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"New Generation" Farmer Cooperatives: The Problem of the "Just Investing" Farmer

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"NEW GENERATION" FARMER COOPERATIVES: THE PROBLEM OF THE "JUST INVESTING" FARMER

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I. INTRODUCTION

"New Generation" is a name that has been given to a number of recently organized farmer cooperatives that share certain distinctive organizational and operational characteristics.[1] These characteristics include the issuance of limited amounts of "delivery rights stock" or its equivalent. This stock confers on its holders the exclusive right and obligation to deliver to the cooperative an amount of a raw agricultural commodity that corresponds to the number of shares held. The cooperative then converts this commodity into a higher-valued product. When the cooperative distributes its surplus earnings from the marketing of this higher-valued product, the distributions are based on delivery rights stockholdings. While these distributions represent the primary financial gain to delivery rights stockholders, the stock issued by some New Generation cooperatives has substantially appreciated in value.

New Generation cooperatives issue delivery rights stock to raise capital and to "line up" the raw commodity that they will convert to a higher-valued product. Farmers typically join the cooperative and purchase the stock to market their production to the cooperative and to receive their proportionate share of the cooperative's surplus earnings distribution. For these farmers, their capital investment serves to create a more profitable "home" for their respective farm's production than would be available otherwise.[2] The cooperative is an extension of their farming operation. The economic linkage between the farms

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1. These cooperatives have also been described as "New Wave" cooperatives (*see* Lee Egerstrom, *The New Wave: New Co-ops Help Growers Gain Larger Share of Food Dollars*, FARMER COOPERATIVES, Oct. 1994, at 27) and "New-Venture" cooperatives (*see* Dennis A. Johnson, *Financing the New-Venture Cooperatives*, ST. PAUL BANK NEWS, Sept.-Oct. 1994, at 25).

2. *See, e.g.*, David K. Smith, *Crop Yield Uncertainty: Issues for New Generation Cooperatives*, 10 SAN JOAQUIN AGRIC. L. REV. 41, 43 (2000) (asserting that a "potential advantage" for growers investing in a New Generation cooperative is providing a "home" for their production).

and the cooperative constitutes a form of "joint" or "mutual vertical integration."[3]

The potential exists, however, that some farmers will not deliver their own production to the cooperative. Instead, they will deliver a commodity purchased on the open market for that purpose. Their motivations for doing so may vary. Some farmers may have acquired their stock with the intention of fulfilling all or part of it with a purchased commodity. Others may find it more convenient to deliver a purchased commodity rather than their own production. Irrespective of their motivations, these farmers, this article contends, are "just investing" farmers. They are farmers who use the cooperative not as a "home" for their production but as a "home" for their capital.

"Traditional" farmer cooperatives neither issue delivery rights stock nor operate in a manner that make them susceptible to the potential for a "just investing" farmer membership. Only New Generation cooperatives have this potential. The recency of their emergence, however, has meant that this potential and its legal consequences have yet to receive either widespread recognition or attention. The purpose of this article, therefore, is to focus attention on the "just investing" farmer problem and to offer an analysis of some of its potential legal consequences to New Generation cooperatives.

Because the potential for a "just investing" farmer problem is rooted in the unique way that New Generation cooperatives operate, this article begins by contrasting the operations of traditional farmer cooperatives with those of New Generation cooperatives. Specifically, Part II of this article briefly describes the basic principles adhered to by most traditional farmer cooperatives. Part III explains how New Generation cooperatives differ from traditional farmer cooperatives.

Part IV describes how the unique features of New Generation cooperatives can directly or indirectly result in some of their members becoming "just investing" farmers. Part V analyzes some of the potential consequences to the cooperative that has "just investing" farmers as members. These include the potential for the cooperative's loss of certain federal income tax benefits under section 521 and Subchapter T of the Internal Revenue Code; the likelihood that delivery rights stock in the hands of a "just investing" farmer would be a "security" under the federal securities laws; the potential for the cooperative's loss of the limited antitrust immunity provided by the Capper-Volstead Act; and the

3. *See* Richard Sexton & Julie Iskow, *Factors Critical to the Success or Failure of Emerging Agricultural Cooperatives, in* GIANNINI FOUNDATION INFO. SERIES NO. 88-3, at 3 (June 1988) (observing that *"agricultural cooperation represents coordination of producers to achieve mutual vertical integration"*).

cooperative's possible ineligibility to borrow funds from Farm Credit System institutions.

II. TRADITIONAL COOPERATIVE PRINCIPLES

A "cooperative" is broadly defined as "a business owned and democratically controlled by the people who use its services and whose benefits are derived and distributed equitably on the basis of use."[4] As this definition reflects, the relationship between a cooperative and its users is based on three interrelated principles: the user-owner principle; the user-control principle; and the user-benefits principle.[5] The user-owner principle holds that a cooperative is owned by those who use it.[6] Since cooperatives usually do more business with members than non-members, user-ownership ordinarily can be equated with member-ownership.

Member equity in traditional farmer cooperatives is contributed primarily through "retained patronage refunds."[7] Retained patronage refunds are sums withheld by the cooperative from its net earnings distributions to its members.[8] These sums, which are deemed to have been paid to the members and then contributed by them to the cooperative, are then applied to the capital needs of the cooperative.[9] When they are no longer needed by the cooperative they are returned to the

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4. Donald A. Frederick, *Co-ops 101: An Introduction to Cooperatives*, *in* USDA COOPERATIVE INFORMATION REPORT 55, at 1 (Apr. 1997). While this definition is likely to be widely accepted, it has been observed that "[t]here is no universally accepted definition of a cooperative." *Id.* Instead, "[c]ooperatives have been defined in many different ways." WAYNE D. RASMUSSEN, FARMERS, COOPERATIVES, AND USDA: A HISTORY OF THE AGRICULTURAL COOPERATIVE SERVICE 1 (1991). In part, the different definitions are attributable to the fact that as cooperatives have changed over time, the definition of a cooperative has evolved to reflect these changes. *See id.* (observing that the definitions "reflect, at least to some extent, how cooperatives have changed over time"). Also, at any given point in time, different views about, or the placement of different emphasis on, the economic, political, social, and legal attributes of a cooperative have produced different definitions. *See* MARTIN A. ABRAHAMSEN, COOPERATIVE BUSINESS ENTERPRISE 2 (1976) (noting that "[u]pon examining the definitions of cooperative business enterprise, we observe that they reflect a wide range of economic, social, and legal views, depending on the background and experience of whoever does the defining"). Finally, among contemporary cooperatives, practices vary from one cooperative to another. *See* John M. Staatz, *The Structural Characteristics of Farmer Cooperatives and Their Behavioral Consequences*, *in* USDA ACS SERVICE REPORT 18, at 33-34 (July 1987) ("Given [this] variation in cooperatives' practices, it probably is impossible to devise a concise definition of a cooperative that would be valid for every organization that appears, on the basis of everyday observation, to act like a cooperative.") (citations omitted).

5. *See generally* John R. Dunn, *Basic Cooperative Principles and Their Relationship to Selected Practices*, 3 J. AGRIC. COOPERATION 83 (1988) (discussing the normative nature of these principles and the degree of adherence to them by agricultural cooperatives).

6. *Id.* at 85.

7. *See* David W. Cobia & Thomas A. Brewer, *Equity and Debt*, *in* COOPERATIVES IN AGRICULTURE 243, 249 (D. Cobia, ed. 1989) (discussing retained patronage refunds and noting that they "represent the bulk (77%) of cooperative equity").

8. *Id.*

9. *Id.*

members who contributed them.[10] Because patronage refunds are paid out of a cooperative's net earnings from business done with or for its patrons, retained patronage refunds constitute equity that is directly derived from the members' use of the cooperative.[11]

Member equity based on the members' use of the cooperative can also be provided through per-unit capital retains.[12] Per-unit capital retains are user investments in a cooperative that are based on the value or volume of the commodity handled by the cooperative.[13] For example, a cooperative might assess a sum on each bushel of corn marketed by the cooperative and retain this sum as a per-unit capital retain until it was no longer needed.[14]

Finally, member equity can be contributed directly through purchases of capital stock.[15] Direct investments through capital stock purchases, however, account for only a small share of member equity in traditional farmer cooperatives.[16] Most rely on retained patronage refunds and per-unit capital retains to meet their capital needs.[17]

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10. *Id.* The legal character of retained patronage refunds is sometimes misunderstood by cooperative members.

> For example, they may tend to think of retained refunds as a debt owed them by the cooperative rather than as an investment. If they view it as a debt, they expect it to be repaid whereas if they understand that it is risk capital, they should realize they may get it, receive benefits in other ways, or could lose it.

Id.; *see also* Sydney Berde, *Overview of Legal Problems Affecting Cooperatives*, 2 AGRIC. L.J. 40, 47 (1980) (noting that "[a] board's discretion as to whether, when, or in what amount it will pay out earnings or redeem patron equities, if reasonably exercised, will ordinarily be sustained by the courts"). As a result, litigation over the redemption of equity can ensue. *See, e.g.*, Mary Beth Matthews, *Current Developments in the Law Regarding Agricultural Cooperatives*, 1 DRAKE J. AGRIC. L. 173, 177 (1996) ("The timely redemption of equity by agricultural cooperatives is an ongoing source of dispute between the entity and its members."); Mary Beth Matthews, *Recent Developments in the Law Regarding Agricultural Cooperatives*, 68 N.D. L. REV. 273, 274-86 (1992) (discussing redemption of equity litigation). *See generally* Robert C. Rathbone & Roger A. Wissman, *Equity Redemption and Member Equity Allocation Practices of Agricultural Cooperatives*, *in* USDA ACS RESEARCH REPORT 124 (Oct. 1993) (discussing the law of equity redemption and equity redemption practices); David W. Cobia et al., *Equity Redemption: Issues and Alternatives for Farmer Cooperatives*, *in* USDA ASC RESEARCH REPORT 23 (Oct. 1982); Robert C. Guenzel, *The Relationship Between Cooperatives and Their Members in Litigation*, 21 S.D. L. REV. 628 (1976) (discussing equity redemption litigation and other litigation between members and their cooperatives).

11. For discussions about the relationship between equity financing and cooperative principles, see Jeffrey S. Royer, *Cooperative Principles and Equity Financing: A Critical Discussion*, 7 J. AGRIC. COOPERATION 79 (1992), *and* Michael J. Cook, *Cooperative Principles and Equity Financing: A Discussion of a Critical Discussion*, 7 J. AGRIC. COOPERATION 99 (1992).

12. Cobia & Brewer, *supra* note 7, at 250-51.

13. *See* Robert C. Rathbone, *Managing Your Cooperative's Equity*, *in* USDA ACS INFORMATION REPORT 56, at 8 (Oct. 1997) (discussing the use of per-unit capital retains).

14. *Id.*

15. Cobia & Brewer, *supra* note 7, at 248.

16. *Id.*

17. *Id.* at 249. For a discussion of capital stock and other financial instruments issued by agricultural cooperatives, see Mary Beth Matthews, *Financial Instruments Issued by Agricultural Cooperatives*, *in* USDA ACS RESEARCH REPORT 68 (Mar. 1988), *and Cooperative Financing and Taxation*, *in* USDA ACS INFORMATION REPORT 1 SECTION 9 (Sept. 1981).

The user-owner principle places economic control in a cooperative's members, and the user-control principle does the same for political control.[18] This principle holds that cooperatives are democratically controlled by their members.[19] Democratic control for most cooperatives means one member, one vote.[20] A minority, however, use "proportional" voting based either on patronage or capital share ownership.[21] Proportional voting regimes usually limit the number of votes a member can cast to avoid displacing "member control" with "money control."[22]

The aversion to "money control" traditionally has been manifested in ways other than the predominance of one-member, one-vote voting regimes and limitations on proportional voting. Most notably, it is found in limitations on returns on equity capital so that members benefit from the cooperative as users, not as investors.[23] Statutory limitations on the dividend rate paid on cooperative capital stock are common.[24] Such limitations also reinforce the user-owner principle because they discourage investments by "outsiders" who stand to gain only from their investment in the cooperative instead of through their use of it.

The user-benefits principle holds that a cooperative's members should benefit from their cooperative in proportion to their use of it.[25] It reflects the practice of distributing annual net earnings or "profits" to the cooperative's members.[26] These distributions are made equitably in the sense that each member's distributive share is proportional to the amount of business the member conducted with the cooperative during the year.[27]

These principles undergird much of cooperative law, including the various state cooperative statutes under which many cooperatives are incorporated.[28] They are also reflected in federal laws pertaining to

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18. *See* ABRAHAMSEN, *supra* note 4, at 59 (noting that the user-owner principle is predicated on the idea that "[w]hen members have substantial equity capital in their cooperative, they have an interest in having a say about how it should be organized and operated" and will be more active in their support for the cooperative).

19. *Id.* at 56.

20. *Id.* at 57.

21. *Id.*

22. *Id.* at 58; *see also* Bruce J. Reynolds et al., *Voting and Representation Systems in Agricultural Cooperatives, in* USDA RBS RESEARCH REPORT 156 (June 1997) (discussing member voting in agricultural cooperatives).

23. ABRAHAMSEN, *supra* note 4, at 60 (observing that limited returns on equity capital are designed to render equity capital "a means to an end not an end in itself").

24. *See, e.g.*, N.D. CENT. CODE § 10-15-20(1)(c) (1995) (providing that the dividend rate on capital stock issued by North Dakota cooperative associations "may not exceed eight percent of its par value for any year, and dividends may not be cumulative").

25. Dunn, *supra* note 5, at 85.

26. *Id.* at 86.

27. *Id.*

28. *See* James R. Baarda, *Cooperative Principles and Statutes: Legal Descriptions of Unique Enterprises, in* USDA ACS RESEARCH REPORT 54 (Mar. 1986) (surveying the incorporation of

farmer cooperatives.[29] Of these three principles, however, it is the user-benefits principle that predominates as a cooperative hallmark. Thus, it is not uncommon to find a traditional farmer cooperative defined in the following manner:

> A cooperative is an organization established for the purpose of purchasing and marketing the products of its members, i.e., shareholders, and/or procuring supplies for resale to the members, whose profits are distributed to the members (in the form of patronage dividends), not on the basis of the members' equity investment in the cooperative, but in proportion to their patronage of it, i.e., the amount of business that each member transacts with it.[30]

III. NEW GENERATION FARMER COOPERATIVES

New Generation farmer cooperatives first began appearing in the 1990s, mostly in the Upper Midwest.[31] One of the earliest and best known is the Dakota Growers Pasta Company based in Carrington, North Dakota.[32] The Dakota Growers Pasta Company converts durum wheat into pasta products, including products bearing its own label.[33] Formed in 1991, it had become the nation's second largest pasta maker by 1998.[34]

Many of the New Generation farmer cooperatives process field crops, such as wheat, soybeans, or corn, into higher-valued products. Some handle livestock. The North American Bison Cooperative, for example, processes and markets bison meat.[35] Formed in 1992, its

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cooperative principles in state cooperative statutes); *see also* James R. Baarda, *State Incorporation Statutes for Farmer Cooperatives, in* USDA ACS INFORMATION REPORT 30 (Oct. 1982) (summarizing the major features of state cooperative statutes). Though every state has a cooperative statute, some have more than one. *Id.* In the latter states, the different statutes apply to different types of cooperatives. *Id.* Several states have recently amended their cooperative statutes. *See* James B. Dean, *Agricultural Cooperatives: An Update*, 73 NEB. L. REV. 228, 237 (1994). For a discussion of the recently amended Colorado cooperative statute, see James B. Dean et al., *The New Colorado Cooperative Act: A Setting for a Business Structure*, 25 COLORADO LAWYER at Dec. 1996 p. 3. Finally, some cooperatives are incorporated under a state statute governing ordinary corporations. *See, e.g.*, Atwood Grain & Supply Co. v. Growmark, Inc., 712 F. Supp. 1360, 1364 (N.D. Ill. 1989) (applying Delaware corporation law to a cooperative governance issue involving an Illinois-based cooperative incorporated under the Delaware business corporation statute).

29. *See, e.g.*, 7 U.S.C. §§ 291-292 (1994 & Supp. V 1999) (providing limited antitrust immunity to farmer marketing cooperatives); I.R.C. § 521 (West 2000) (providing favorable tax treatment to qualifying farmer marketing and supply cooperatives).

30. Columbus Fruit & Vegetable Coop. Ass'n, Inc. v. United States, 7 Cl. Ct. 561, 563 (1985).

31. Des Keller & Jim Parrico, *The Boom in Value-Added Co-ops*, PROGRESSIVE FARMER, Sept. 1998, at 1.

32. *Id.*

33. *Id.*

34. *Id.*

35. Dan Campbell, *Temperature Rising: Co-op Fever is Still Sizzling Across North Dakota; But Will the First Failure Cause it to Dissipate?*, FARMER COOPERATIVES, Aug. 1995, at 12.

members raised $1.6 million to construct a new processing plant in New Rockford, North Dakota.[36] "Live bison go in one side of the plant, and white packages of neatly trimmed buffalo meat come out the other."[37] In Minnesota and elsewhere, corn farmers have formed cooperatives that raise hogs, with the hogs consuming corn produced by the cooperatives' members.[38]

These cooperatives were formed so that farmers could "gain access to an increased share of the consumers' food dollar."[39] To the extent that they are successful, they can increase the wealth of their members.[40] They also have the potential for adding wealth to the communities in which they are located by creating new employment opportunities in their facilities. For these reasons, New Generation cooperatives are commonly viewed as instrumental in rural development.[41]

For the same reasons, numerous New Generation cooperatives are operating or are in the planning stage.[42] In North Dakota, where a substantial number of New Generation cooperatives are located, sixty-seven cooperatives were formed from 1990 through 1997.[43] This averages to 8.3 cooperatives formed per year.[44] Twenty-six of the sixty-seven new cooperatives add value to raw agricultural products.[45]

The capital needs of a New Generation cooperative can be substantial.[46] Even the organizational process to form a new cooperative can entail substantial expenditures.[47] A cooperative that intends to process raw agricultural products into value-added products will likely face competition from already established businesses.[48] For this reason, engaging the services of consultants for the preparation of a marketing feasibility study is usually necessary.[49] This study and the business plan that emanates from it add to the usual organizational costs that are

36. *Id.*

37. *Id.*

38. John Reilly & Bruce Reynold, *Furrow to Farrow: New Hog Technology Helps Local Cooperatives Add Value to Corn*, FARMER COOPERATIVES, Apr. 1994, at 4.

39. Andrea Harris et al., *New Generation Cooperatives and Cooperative Theory*, 11 J. OF COOPERATIVES 15, 15 (1996).

40. *See, e.g.*, Dan Looker, *Unite for Success: Value-Added Co-ops Help Families Capture Greater Margin in the Food Chain*, SUCCESSFUL FARMING, June 15, 1999, at 16.

41. *See generally* LEE EGERSTROM, MAKE NO SMALL PLANS: A COOPERATIVE REVIVAL FOR RURAL AMERICA 217-43 (1994) (discussing the contributions that New Generation cooperatives have made to rural development).

42. William Patrie, *Creating 'Co-op Fever': A Rural Developer's Guide to Forming Cooperatives*, *in* USDA RBS SERVICE REPORT 54, at 5 (July 1998).

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.* at 13.

47. *Id.* at 15-17.

48. *Id.* at 20.

49. *Id.* at 12.

incurred in the formation of a cooperative.[50] The organizational budget for the Dakota Growers Pasta Company, for example, was $300,000.[51]

The more substantial costs, however, are the capital expenditures required for the construction, purchase, or lease of a processing facility.[52] Again using Dakota Growers as an example, its organizers contemplated a state-of-the-art facility,[53] and they set an equity goal for the capitalization of its pasta plant at $12.5 million.[54] Once a facility is built or acquired, more capital is needed to hire its managerial and operational personnel.[55]

New Generation cooperatives, like traditional farmer cooperatives, substantially rely on member equity to meet their capital requirements.[56] They are unique, however, in requiring an up-front equity investment from their members in the form of delivery rights stock purchases.[57] Partially driven by the substantial costs of establishing a value-added cooperative, this investment gives the cooperative the necessary member-contributed "start-up" capital early in the organizational process.[58] It also serves another purpose because subscriptions to delivery rights are the most meaningful indication of interest in the cooperative from farmers eligible to join it.[59]

Since delivery rights are usually measured by units of production, such as bushels or acres, each delivery right represents the right to patronize the cooperative to the extent of that unit.[60] Delivery rights, therefore, constitute "units of participation" in the cooperative.[61] A member of a New Generation cooperative can only patronize the cooperative by holding one or more units of participation, and then only to the extent of the number of units of participation that the member holds.[62]

A common method used by New Generation cooperatives to establish delivery rights is to link them to a class of stock in the cooperative.[63] A cooperative might establish two classes of common stock, Class

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50. *Id.* at 8.
51. *Id.* at 4.
52. *Id.*
53. Kim Zueli et al., Dakota Growers Pasta Company and the City of Carrington, North Dakota: A Case Study 14 (Mar. 1998) (unpublished manuscript, copy on file with author).
54. Patrie, *supra* note 42, at 4.
55. *Id.* at 17.
56. *Id.* at 15.
57. *Id.* at 2.
58. *Id.* at 15.
59. *See id.* at 16.
60. *Id.* at 2.
61. *Id.*
62. *Id.* at 3.
63. *Id.*

A and Class *B*.[64] Class *A* common stock is voting membership stock.[65] Each member is required to purchase one share of Class *A* stock, but no delivery rights are attached to it. Instead, delivery rights are attached to Class *B* common stock.[66]

The total amount of delivery rights stock available is linked to the amount of the commodity that the cooperative can process annually.[67] Once all of the authorized delivery rights stock has been subscribed, membership in the cooperative is "closed."[68] Membership is closed because the admission of members who did not hold this stock would frustrate the purpose of being a member in the cooperative.[69] The economic value of membership resides exclusively in the holding of delivery rights stock because its ownership represents the only means for patronizing the cooperative.[70] Once this stock is fully subscribed there is no economic reason, from the perspective of either the cooperative or a potential member, for anyone else to join the cooperative.[71]

Like traditional farmer cooperatives, New Generation cooperatives set a relatively low or nominal price for the single share of voting membership stock each member must purchase.[72] The price of delivery rights stock, on the other hand, is set at a sum large enough so that the sale of a preestablished amount of stock will generate at least the minimum amount needed to satisfy the cooperative's initial capital requirements.[73] In other words, "[t]he initial price of each share is generally determined by taking the total amount of capital the cooperative wishes to raise for start up and dividing it by the number of units of farm product that can be absorbed by the processing facility."[74] Under this formula, the sale of delivery rights stock provides the bulk of the member-contributed equity.[75] Delivery rights stock, therefore, is sometimes denominated by the cooperative as "equity stock."[76]

64. *Id.*
65. *Id.* at 16.
66. *Id.*
67. *Id.* at 3.
68. *Id.* at 13.
69. *Id.* at 3.
70. *Id.*
71. *Id.* Traditional farmer cooperatives are usually "open cooperatives" because their membership always remains open to persons eligible for membership. *See* Harris et al., *supra* note 39, at 17.
72. Patrie, *supra* note 42, at 16.
73. Harris, *supra* note 39, at 17.
74. *Id.*
75. *Id.* at 16. "In general, the [New Generation cooperatives] have followed recommendations to raise between 30 and 50 percent of their total capital requirements through the sale of delivery right shares. Remaining capital requirements are met through debt or the issue of preferred shares." *Id.*
76. *Id.*

By securing a substantial equity investment from its members before it begins operations, the cooperative is better able to raise debt capital and to withstand early revenue shortfalls.[77] At the same time, the cooperative ensures that much of the capitalization of the cooperative is provided by those who will patronize it. It also aligns each member's investment with the member's anticipated patronage.[78]

Attaching delivery rights to stock is commonly accomplished by the cooperative's articles or bylaws and is often supplemented by a members' agreement.[79] These contractual instruments specify that each share of the stock entitles its holder to deliver to the cooperative a specified amount of the commodity on an annual basis.[80] They also tie the right to deliver the product to the obligation to deliver according to a schedule established by the cooperative.[81] In addition, the contract agreement may specify the price or the formula for calculating the price that the member will receive for the product when it is delivered.[82]

The delivery obligation typically remains in force even if the member cannot deliver the requisite quantity from his or her own production.[83] In that event or in the event that the product delivered does not meet the cooperative's quality standards, the member must obtain the product from another source.[84] Thus, a member agreement might provide as follows:

> If the Member is unable to deliver the committed number of [units of the raw commodity] from the Member's own production due to crop failure or similar cause, that circumstance shall not excuse delay or non-delivery. Instead, the Member shall

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77. *Id.* at 19. As Harris notes:

> [t]he generation of significant up-front equity contributions from members facilitates the involvement of [New Generation cooperatives] in capital-intensive, value-added processing activities. Up-front equity provides a significant equity base that allows the weathering of business cycles. The acquisition of debt financing is also made easier because banks are given a solid indication of producers' commitment to the project.

Id.

78. *Id.* at 16. This alignment is "an example of a very strict base capital plan in that a member's patronage and a member's equity are always equal." *Id.* A "base capital plan" is one method by which a cooperative returns to its members the member-contributed equity that the cooperative no longer needs. *Id.* It contemplates adjustments to each member's equity requirements to keep each member's equity in line with each member's patronage. *Id.* Based on the cooperative's need for capital and each member's respective share of patronage of the cooperative, under-invested members must add to their capital investment, while over-invested members have capital returned. *See* Robert C. Rathbone & Donald R. Davidson, *Base Capital Financing of Cooperatives*, *in* USDA RBS COOPERATIVE INFORMATION REPORT 51, at 11 (Nov. 1995) (discussing base capital plans).

79. *See* Patrie, *supra* note 42, at 2-3.

80. *See* Harris, *supra* note 39, at 16.

81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.*

> obtain [the commodity] from other sources at his cost, and shall deliver it to the Cooperative, just as if it had been actually produced by Member. It is the intention of the parties that the Member shall be obliged to deliver all [the commodity] committed to be sold and delivered under this Agreement in all events, unless the obligation shall be terminated or canceled pursuant to the express terms of this Agreement.[85]

Substantial annual quantities of the raw product may be required for a New Generation cooperative's facility to operate efficiently. A relatively small dry-mill ethanol facility that produces fifteen million gallons of ethanol per year, for example, uses about 6.5 million bushels of corn annually.[86]

For most New Generation cooperatives that process large amounts of an annually-produced agricultural product, the cost of constructing facilities capable of storing all of the raw product that their members harvest in the fall is prohibitive. Even if these costs were not prohibitive, the maintenance of massive storage facilities would be an inefficient use of the cooperative's resources. Unless alternative uses could be found for the space that would become available as the product was consumed between harvests, an ever-increasing amount of the storage space would be idle during the year. Leasing storage space would be an alternative, but this option may be limited by the availability of existing facilities within a convenient distance of the cooperative's processing facility and the cooperative's ability to bear the cost. For these reasons, New Generation cooperatives typically do not build or lease facilities capable of storing all of the raw product that their members are obligated to deliver annually.

Instead of using cooperative-owned or leased storage, New Generation cooperatives usually manage the flow of the raw product to their facilities by establishing delivery schedules for each member. These schedules require the members to fulfill their annual delivery obligation in installments spaced throughout the year.[87] The obligation to adhere

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85. Dakota Growers Pasta Co. Growers Agreement ¶ 1(a) *accompanying* Offering Circular for Dakota Growers Pasta Company, a North Dakota Cooperative Association (March 26, 1992).

86. Anthony C. Crooks, *Cooperatives and New Uses for Agricultural Products: An Assessment of the Fuel Ethanol Industry*, *in* USDA RBS RESEARCH REPORT 148, at 15 (Sept. 1997). For a discussion of the role of New Generation cooperatives in the production of ethanol, see Mary Farrell-Stieve, *Power Formula*, RURAL COOPERATIVES, May-June 2000, at 7, *and* Pamela J. Karg, *Fill'er Up!*, RURAL COOPERATIVES, May-June 2000, at 8.

87. *See, e.g.*, Dakota Growers Pasta Co. Growers Agreement, *supra* note 85, ¶ 2. Delivery schedules place most, if not all, of the responsibility for storage on the cooperative's members. The members' storage options typically include on-farm storage and storage in elevators or other facilities, including those owned or operated by other cooperatives. Storage, whether on- or off-farm, has a cost. Members must either build storage facilities, maintain existing facilities, or pay storage fees to

to such a schedule is imposed by a member agreement containing, for example, the following provision:

> Member agrees to tender delivery of the [raw agricultural product] in one or more installments, in accordance with the delivery schedule established by the Cooperative and mailed by ordinary mail to the Member. The delivery schedule shall designate one or more dates and places of delivery, which may be an elevator or other facility not owned by the Cooperative.[88]

Member agreements typically provide that the members will receive a payment upon delivery of the commodity to the cooperative.[89] This payment is often based on a percentage of the current local market price for the commodity, although some cooperatives pay the current market price at the time of the delivery.

Member agreements also usually provide that the cooperative has the option of purchasing any amount of the raw product that a member fails to deliver under the agreement.[90] The member who fails to make the delivery is responsible for reimbursing the cooperative for its purchases on behalf of the defaulting member, as the following provision provides:

> If the Member fails to make delivery or the Cooperative rejects any tender of delivery, the Cooperative may make in good faith and without unreasonable delay any reasonable purchase of [the raw agricultural product] in substitution for that due from the Member. The Cooperative may recover from the Member as damages the difference between the cost of substitute [raw product] and the advance payment, and any incidental or consequential damages.[91]

If a member is unable to deliver the commodity because of a crop or other production failure, the member is often obligated to purchase a sufficient amount of the product to satisfy his or her delivery obligation.[92] The intent of such provisions is to limit the burden on the cooperative that would result if the cooperative had to make the substitution arrangements.

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the operator of an elevator or other facility. If off-farm storage is used, members must bear the cost of transporting their production both to the storage facility and to the delivery point designated in their delivery schedule. In addition to incurring these costs, members usually bear the risk of the loss of the product until it is delivered to the cooperative. *Id.*

88. *Id.*

89. *Id.* ¶ 3.

90. *See* Patrie, *supra* note 42, at 2.

91. Dakota Growers Pasta Co. Growers Agreement, *supra* note 85, ¶ 7(c).

92. *Id.* ¶ 1(a).

Traditional farmer marketing cooperatives sometimes obligate their members to grow a crop and to market all or a specified portion of their crop production through the cooperative.[93] However, they do not require their members to deliver a substitute for their own production.[94] New Generation cooperatives stand alone among farmer cooperatives in requiring substitutions.

New Generation cooperatives permit shares of their delivery rights stock to be transferred to other eligible farmers, subject to the approval of their boards of directors.[95] Board approval is intended to prevent delivery rights stock from being held by persons not eligible for cooperative membership.[96] Eligibility is ordinarily limited to producers of the product processed by the cooperative.[97]

The board does not set the transfer price.[98] Instead, the parties to the transaction set the price, and the value of the stock is likely to reflect its earning potential.[99] As to this value,

> [t]he share prices during the operation phase reflect the returns members expect to receive from the cooperative over time. In valuing the returns, members can be expected to examine the difference between the cost of producing the farm product and the revenue generated from processing this product and selling it to a further downstream market.[100]

The ability of delivery rights stock values to rise or fall is illustrated by the experiences of two New Generation cooperatives. Delivery rights shares in the Dakota Growers Pasta Company were initially offered at $3.85 each.[101] By the end of 1998 they were selling for $10.00 a share.[102] When adjusted for an earlier three-for-two stock split, this price is equivalent to $15.00 per share.[103] On the other hand, shares in Snowflake, a Minnesota cooperative, became worthless when the cooperative

93. *See generally* Roger A. Wissman, *Marketing Coordination in Agricultural Cooperatives, in* USDA RBS RESEARCH REPORT 159 (Sept. 1997) (discussing the use of marketing agreements between farmer marketing cooperatives and their members); John D. Reilly, *Cooperative Marketing Agreements: Legal Considerations, in* USDA ACS RESEARCH REPORT 106 (July 1992) (discussing various legal aspects of marketing agreements).

94. Neil E. Harl, 14 AGRICULTURAL LAW § 133.02[3] (1993).

95. *See* Harris et al., *supra* note 39, at 16.

96. *See* Patrie, *supra* note 42, at 3.

97. *See* Harris et al., *supra* note 39, at 24 (noting that New Generation cooperative membership is typically limited to producers of one type of a commodity).

98. *See* Patrie, *supra* note 42, at 3.

99. *Id.*

100. Harris et al., *supra* note 39, at 17.

101. Lon Tonneson, *Are We Rich Yet? Farmers Ride the Value-Added Investment "Roller Coaster,"* THE FARMER, Jan. 1999, at 8.

102. *Id.*

103. *Id.*

closed in 1998, two years after it raised $500,000 from sixty-eight farmer members.[104] Less drastic reductions in stock prices occurred for several other New Generation cooperatives in the Upper Midwest.[105]

The transferability of delivery rights stock offers potential benefits to the cooperative. Specifically, stock value appreciation "may provide an incentive for producers to not only become involved in the initial formation of the cooperative, but to also further the success of the cooperative beyond the initial expectations."[106] In addition, this transferability allows the cooperative to "line up" the commodity from the transferee when a member exits the cooperative or reduces his or her participation in it.[107]

This transferability feature distinguishes New Generation cooperatives from traditional farmer cooperatives.[108] The stock in the latter either is not transferable or, if it is transferable, no market exists for it because it is readily available for purchase at its par value from the cooperative.[109] Therefore, the economic benefits flowing from traditional farmer cooperatives do not include gains from the appreciation in stock value.[110]

Finally, successful New Generation cooperatives can pay high levels of cash patronage refunds because they established their needed equity before beginning their operations through the sale of equity stock.[111] They do not have to retain significant portions of the patronage refunds paid to the members to build equity.[112] This contrasts with the practices of most traditional farmer cooperatives which rely on retained patronage refunds as their primary source of member equity.

IV. ILLUSTRATIONS OF THE "JUST INVESTING" FARMER PROBLEM

"Just investing" farmers are New Generation cooperative members who do not deliver their own production to the cooperative. Instead, they purchase, or have purchased for them, all or a portion of the raw product obligated for delivery. They do this for a variety of reasons, as

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104. *Id.* at 9.
105. *Id.* at 9-11.
106. Harris et al., *supra* note 39, at 20.
107. *Id.* at 19.
108. *Id.* at 26.
109. Jeffrey S. Royer, *Cooperative Principles and Equity Financing: A Critical Discussion*, 1992 J. AGRIC. COOPERATION 79, 92-93 (1992).
110. *Id.*
111. *See* Patrie, *supra* note 42, at 3.
112. *Id.*

illustrated by the following hypothetical farmers, each of whom is a member of the same hypothetical ethanol cooperative.

Farmer *A* acquired delivery rights stock solely as an "investment." He did not intend to provide a "home" for the corn he produced. Instead, he purchased the stock to participate in the cooperative solely on a cash basis by expending the sums needed to purchase the corn he was obligated to deliver. His goal was to realize the value-added gain on the purchased corn and any appreciated value in his delivery rights stock. While he might occasionally deliver some of his own production to the cooperative, he continues to market most of his own production elsewhere or to put it to another use, such as feeding it to his livestock.

Farmer *B*, on the other hand, bought delivery rights stock primarily to provide a "home" for her own production. However, attracted by the same opportunities for financial gain that motivated Farmer *A* to make his purchase, Farmer *B* bought a larger quantity of delivery rights stock than she could fulfill from her farm's production. Her intention and subsequent practice was to cover the shortfall by delivering purchased corn.

Farmer *C*, unlike Farmers *A* and *B*, bought delivery rights stock solely to provide a "home" for his production. He limited his corresponding delivery obligation to a quantity he could regularly produce. However, he soon found it inconvenient and costly to comply with the cooperative's delivery schedule. He therefore marketed the portion of his production that he did not want to keep in storage until its scheduled delivery. When this portion was due for delivery, he purchased a corresponding amount of corn and delivered it to the cooperative.

Farmer *D*, like Farmer *C*, bought delivery rights stock solely to provide a "home" for her production. Also like Farmer *C*, she bought only an amount of stock she could fulfill with her farm's production. On occasion, however, she failed to make all of her scheduled deliveries. On these occasions the cooperative acted pursuant to its uniform member agreement and purchased corn to cover the deliveries Farmer *D* failed to make. The cost of these purchases was charged to her account with the cooperative.

Farmers *A*, *B*, *C*, and *D* are alike in that they filled at least a portion of their delivery obligation with purchased corn. They are not alike, however, in their motivations for acquiring delivery rights stock. Nevertheless, for purposes here, each is a "just investing" farmer. Irrespective of their motivations, each has made the economic equivalent of a cash

investment in the cooperative with the expectation of a greater cash return.[113]

As Farmer *D*'s circumstances illustrate, when a cooperative purchases the commodity on behalf of a member who has failed to deliver, the cooperative essentially compels that member to become a mere investor. Additionally, as suggested by Farmer *C*'s response to what he considered to be an inconvenient delivery schedule, a cooperative can unintentionally create a situation in which a member becomes a mere investor with respect to at least some of his or her participation in the cooperative.

While it is not likely that many members will default on their delivery obligation, Farmer *C*'s response is unlikely to be unique among the members of a cooperative with a delivery schedule spread throughout each year. To the contrary, a cooperative's need for a continuous flow of large quantities of a commodity to its facility is likely to motivate the cooperative to take one of two actions. First, recognizing that its delivery schedules can be inconvenient and costly for its members, the cooperative will readily accept a purchased commodity as a substitute for member production. Second, the cooperative will go further than just accepting a purchased commodity. It will establish or assist its members in establishing a permanent mechanism for the very purpose of facilitating deliveries of purchased commodities in lieu of member-produced production.

A cooperative, for example, might establish a physical inventory of a fungible member-produced commodity that has been commingled, segregated, and stored in one or more locations. Quantities of the commodity could be withdrawn from this inventory by the cooperative's members in exchange for a purchase price or an equivalent deposit of the commodity at some earlier or later time. While such a mechanism would ensure that all of the commodity delivered to the cooperative was member-produced, some deliveries might still be purchased deliveries unless an equivalent exchange was the exclusive acquisition method. In addition, from a practical perspective, this option puts the cooperative or its members in the business of storing the commodity or at least being directly responsible for the storage costs and risks.

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113. A New Generation cooperative might influence local supply and demand for the raw product sufficiently to raise the local open market price for the raw commodity. One could therefore argue that even the cash investor derives a benefit as an agricultural producer since the cash investment in the cooperative may serve to increase the value of his or her agricultural production sold and delivered elsewhere. This benefit, however, does not justify characterizing the "just investing" farmer as participating in the cooperative in his capacity as an agricultural producer.

Alternatively, a cooperative might make available to its members a third-party purchasing agency whose function would be to locate and acquire the commodity on behalf of the cooperative's members from various sources, including the open market. While the use of this option would still require members who used it to bear whatever third-party storage and other costs were reflected in the commodity's purchase price, it could be especially attractive if the purchasing agency could make deliveries directly to the cooperative at an overall lower cost than purchases from or through other sources. Such a mechanism, however, would be a virtual invitation for members to deliver purchased product if the members were so motivated by inconvenient delivery schedules or other considerations.

The potential for a "just investing" farmer-membership, therefore, could be realized. For one or more of several reasons, not the least of which is the attractiveness of delivery rights stock as an "investment," a cooperative's members may desire to deliver purchased product to the cooperative. The cooperative, in turn, may do nothing to discourage such purchases and may actually facilitate them so that it can maintain a continuous flow of the raw product to its facility. As a result, a significant portion of the cooperative's membership can become "just investing" farmers.

V. POTENTIAL CONSEQUENCES TO THE COOPERATIVE OF THE "JUST INVESTING" FARMER-MEMBER

A cooperative with "just investing" farmer-members can face adverse legal consequences. The discussion that follows addresses this potential with respect to the Internal Revenue Code, the federal securities and antitrust laws, and the Farm Credit Act.

A. INTERNAL REVENUE CODE SECTION 521

1. *Section 521 Requirements and Exceptions*

New Generation cooperatives often seek "exempt" status under section 521 of the Internal Revenue Code.[114] Section 521 cooperatives are entitled to two federal income tax deductions that are not available to "nonexempt" cooperatives.[115] For most New Generation cooperatives

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114. A cooperative seeking section 521 status must apply for it. Successful applicants receive a letter of exemption. *See* Rev. Proc. 84-46, 1984-1 C.B. 541. The exemption is lost, however, if the cooperative fails to meet the section's requirements, and the loss may be retroactive. *Id.*

115. In addition to the deductions available to nonexempt cooperatives, section 521 cooperatives can deduct dividends paid on capital stock and patronage-based allocations of income from sources

that seek section 521 status, however, the primary benefit is the exemption from the federal securities registration requirements that the status provides.[116] This exemption is advantageous because it avoids the legal expenses associated with determining whether the stock issued by the cooperative, especially the delivery rights stock, is a "security." Moreover, if the stock is a security or there is a substantial risk that it will be deemed a security, an exemption avoids the costs and delays associated with the registration process.

The eligibility requirements for section 521 are demanding and can significantly limit the way a cooperative operates. Section 521 status is limited to "farmers,' fruit growers,' or like associations organized and operated on a cooperative basis."[117] The association must be organized and operated "for the purpose of marketing the products of members or other producers" or "for the purpose of purchasing supplies and equipment for the use of members or other persons."[118] "Marketing" includes value-added processing, but the products marketed must be those "of members or other producers."[119] With limited exceptions, this requirement "means [that] all products marketed by a section 521 cooperative must be provided by the farmer producer of that product."[120]

A section 521 cooperative must return to the members and other producers whose products are marketed "the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or value of the products furnished by them."[121] Therefore, if it does business with nonmembers, it must treat members and nonmembers alike.[122] Both groups must be entitled to receive distributions of the cooperative's net earnings on a patronage basis.[123]

If the association has capital stock, dividends on the stock cannot exceed "the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater."[124] "[S]ubstantially all" of the holders of capital stock, other than nonvoting preferred stock, must

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other than patronage. I.R.C. § 1382(c)(1) & (c)(2)(A) (West 2000).

116. 15 U.S.C. § 77c(a)(5)(I) (1994).

117. I.R.C. § 521(b)(1) (West 2000); *see also* Treas. Reg. § 1.521-1(a)(1) (Nov. 26, 1960). The meaning of "operating on a cooperative basis" is discussed at *infra* Part V.B.

118. I.R.C. § 521(b)(1)(A) & (B); *see also* Treas. Reg. § 1.521-1(a)(1) & (b).

119. Donald A. Frederick, *Income Tax Treatment of Cooperatives: Internal Revenue Code Section 521, in* USDA RBS INFORMATION REPORT 44 pt.4, at 13 (June 1996) (citing Rev. Rul. 77-384, 1977-2 C.B. 198 (restating Mim. 3886, X-2 C.B. 164 (1931)) and Rev. Rul. 81-96, 1981-1 C.B. 360).

120. *Id.* at 15.

121. I.R.C. § 521(b)(1)(A).

122. *Id.*

123. *See* Roger A. McEowen & Neil E. Harl, *Taxation of Cooperatives*, 744 TAX MGMT. (BNA) at A-8 (noting that "[t]here must be equality of treatment between members and nonmembers").

124. I.R.C. § 521(b)(2); *see also* Treas. Reg. § 1.521-1(a)(2). These rate limits are applied "on the value of the consideration for which the stock was issued." I.R.C. § 521(b)(2).

be producers who patronize the cooperative.[125] "Substantially all" means at least eighty-five percent.[126]

Finally, business done with nonmembers must not exceed business done with members.[127] Business done with the United States is excluded for purposes of this requirement, as it is for the other requirements.[128]

Three of these requirements can pose problems for a cooperative whose membership consists of "just investing" farmers. Specifically, they are the requirements that a section 521 cooperative: (1) can only market or process the agricultural "products of members or other producers;" [129] (2) must do more business, measured by value, with members than nonmembers;[130] and (3) must return its net earnings to all patrons, members and nonmembers alike, based on their patronage.[131] Subject to three exceptions, the requirement of marketing or processing only the "products of members or other producers" limits a section 521 cooperative to marketing or processing only the products of producers.[132] A "producer" is one "who bears the risks of producing, cultivating, operating or managing a farm for gain or profit."[133] Thus, a producer does not include someone who purchases an agricultural product at or after its harvest, because he or she would avoid the risks associated with its production.

In *Dr. P. Phillips Cooperative v. Commissioner,*[134] for instance, all of the cooperative's members owned fruit groves that produced fruit marketed through the cooperative.[135] They were therefore producers as to that fruit. Several of the members, however, also purchased fruit from nonmembers that was being picked or already had been picked, and they marketed this purchased fruit through the cooperative.[136] Construing a predecessor statute to section 521, the Tax Court ruled that these members were not growers or producers with respect to the purchased

125. I.R.C. § 521(b)(2).

126. *See* West Cent. Coop. v. United States, 758 F.2d 1269, 1271 (8th Cir. 1985) (upholding Rev. Rul. 73-248, 1973-1 C.B. 295). This measure is satisfied if the requisite percentage of patrons have the right to vote at the annual stockholders' meeting following the close of the taxable year. Farmers Coop. Co. v. Commissioner, 822 F.2d 774, 779 (8th Cir. 1987).

127. I.R.C. § 521(b)(4). If the cooperative purchases supplies and equipment for its members and other producers, the value of purchases by nonmembers and nonproducers cannot exceed fifteen percent of the value of all purchases. *Id.*

128. *Id.* § 521(b)(5).

129. *Id.* § 521(b)(1)(A).

130. *Id.* § 521(b)(4).

131. *Id.* § 521(b)(1).

132. *Id.* § 521.

133. Farmers Coop. Creamery Ass'n of Cresco, Iowa v. United States, No. C 78-2045, 1981 WL 1798 at *3 (N.D. Iowa 1981).

134. 17 T.C. 1002 (1951).

135. *Phillips Coop.*, 17 T.C. at 1008.

136. *Id.* at 1008-09.

fruit because they had not borne the risks of its production.[137] The court accordingly held that the cooperative was not entitled to the exemption afforded by the statute since the cooperative's marketing activities were not limited to marketing for producers during the tax years at issue and no exception applied.[138]

The three exceptions to this requirement are limited.[139] The first applies to bona fide "emergency purchases . . . made for the sole purpose of meeting pre-existing contractual commitments to facilitate dealings with member patrons and not for any purpose of investment or profit."[140] If, for example, a natural disaster resulted in a cooperative not receiving the normal production from its members and the cooperative had preexisting contractual obligations to deliver a normal volume of that product to its customers, it could purchase the product from non-producer sources without losing its section 521 eligibility.[141]

This exemption could excuse a New Generation cooperative's processing of purchased commodities on a few extraordinary occasions. It would not cover, however, the cooperative's regular acceptance of deliveries of purchased commodities.[142] It would neither allow a cooperative to purchase product on behalf of members who defaulted on a delivery nor permit the cooperative to process with impunity the purchased commodities of members who held more delivery rights stock than they could fulfill through their own production.[143]

The second exception applies to ingredient purchases, such as a dairy cooperative's purchase of sugar for the manufacture of ice cream.[144] Ingredient purchases are limited "to those necessary to put into marketable condition the agricultural products of producers marketed by a farmers' marketing cooperative association."[145] Thus, a dairy cooperative's purchase of additional cream, a product produced by its members, would not qualify as an ingredient purchase.[146] This exception would not apply to the cooperative with "just investing" farmers because the purchased product these farmers delivered would be the

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137. *Id.*

138. *Id.* at 1009.

139. *See, e.g.*, Farmers Coop. Creamery Ass'n v. United States, No. C 78-2045, 1981 WL 1798 (N.D. Iowa 1981).

140. Rev. Rul. 69-222, 1969-1 C.B. 161. The emergency must be genuine. *Id.* Repeated purchases of nonpatron-produced product under this exception create an inference to the contrary. *See* Tech. Adv. Mem. 80-47-006 (July 29, 1980).

141. Rev. Rul. 69-222, 1969-1 C.B. 161.

142. *Id.*

143. *Id.*

144. Rev. Rul. 75-4, 1975-1 C.B. 165.

145. *Id.* at 166.

146. *Id.*

primary commodity the cooperative converted into a higher-valued product.[147]

The third exception covers incidental or sideline purchases.[148] These purchases must be limited to those necessary to market producer products, and their volume and financial return must not be substantial in relation to the sale of producer products.[149] For example, a dairy cooperative that sold milk at retail outlets might be able to market eggs purchased from a wholesaler or other non-producer to promote its milk sales.[150] As with the second exception, this exception would also not apply to the cooperative with "just investing" farmers with respect to their deliveries of a purchased commodity that was the primary commodity handled by the cooperative.[151]

A cooperative that markets or processes products purchased by its members can also lose its section 521 status for doing more business with nonmembers than members and for failing to pay patronage refunds to all with or for whom it does business.[152] Revenue Ruling 67-152 illustrates such a result. The taxpayer was a cooperative that packed, shipped, and marketed fruit supplied by its members.[153] Its members produced fruit, but they also delivered fruit that they had purchased on the open market.[154] In the tax years in question, the value of the purchased fruit sales exceeded the value of the member-produced fruit sales.[155] The cooperative's net earnings were distributed to its members, based on the value of the fruit that they delivered.[156] No distributions, however, were made to the producers whose fruit was purchased by the members on the open market.[157]

The IRS ruled that the cooperative was ineligible for section 521 for two reasons.[158] First, the cooperative had done more business with nonmembers than members.[159] Second, "by marketing products of nonmembers as those of its members," the cooperative also had failed to return its net marketing proceeds "to producers on the basis of the quantity or value of products furnished by them."[160]

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147. *Id.*
148. Tech. Adv. Mem. 80-47-006 (July 29, 1980).
149. *See* Priv. Ltr. Rul. 87-05-091 (Nov. 7, 1986).
150. *See* Rev. Proc. 67-37, 1967-2 C.B. 668.
151. *Id.*
152. Rev. Rul. 67-152, 1967-1 C.B. 147, *superseding* I.T. 3853, 1947-1 C.B. 42.
153. *Id.*
154. *Id.*
155. *Id.*
156. *Id.*
157. *Id.*
158. *Id.*
159. *Id.*
160. *Id.* at 147-48.

The IRS noted the longstanding distinction between a "producer" and one who purchases an agricultural product at or after harvest.[161] To this distinction it added that "products," as used in section 521, means "products grown or otherwise produced by [the patron] for whose account[] such products are marketed."[162] Here, however, the purchased fruit was delivered on the account of the members who had purchased it.[163] The marketing of it was business with nonmembers because the fruit was produced by nonmembers.[164] Since the value of the member-purchased fruit exceeded the value of the member-produced fruit, the cooperative had not complied with the section 521 requirement that it must do more business with members than nonmembers.[165]

The IRS also observed that a "patron" is a person who is legally entitled to share in the cooperative's net earnings on a pro rata patronage basis, whether or not the person is a member of the cooperative.[166] A section 521 cooperative may elect to market only the products of its members. If, however, it markets the products of both members and nonmembers it must treat members and nonmembers alike with respect to returns based on patronage.[167] This equality of treatment requirement, when coupled with definitions of "products" and "patron," dictates that a section 521 cooperative can only market or process products produced by persons who are legally entitled to share in the cooperative's net earnings on a pro rata patronage basis.[168] Consequently, a section 521 cooperative cannot market or process nonpatron-produced products on the account of a member.[169]

This reasoning is consistent with the IRS's recognition that there are circumstances in which a cooperative can market products that have been produced by nonmembers on behalf of its members without losing section 521 eligibility.[170] For example, in Revenue Ruling 55-496 the membership of the taxpayer cooperative included individual producers, partnerships, corporations, and other marketing associations.[171] All of

161. *Id.* (relying principally on Dr. P. Phillips Coop. v. Commissioner, 17 T.C. 1002 (1951)).
162. *Id.* at 147.
163. *Id.*
164. *Id.*
165. *Id.*
166. *See* Treas. Reg. § 1.1388-1(e) (Apr. 2, 1963) (defining a patron as "any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative").
167. I.R.C. § 521(b)(1) (West 2000).
168. *Id.*
169. *See* Land O'Lakes, Inc. v. United States, 514 F.2d 134, 139-41 (8th Cir. 1975) (denying section 521 status to a cooperative that received products from persons who were not treated as patrons and that were acquired by the cooperative through a non-producer member of the cooperative).
170. *See* I.R.C. § 521(b)(1).
171. Rev. Rul. 55-496, 1955-2 C.B. 268.

the members were producers, but some members marketed the products of nonmembers through the cooperative.[172] These members, however, had entered into written agency agreements with the nonmember producers.[173] Under these agency agreements, the nonmember producers retained title to the product.[174] The members, through whom the product was delivered, were also obligated to return to the nonmember-producers the net proceeds of the sale of their respective products.[175] The cooperative supervised the performance of these agency agreements.[176] The IRS ruled that these agency arrangements would not render the cooperative ineligible for section 521, so long as the value of the sales of nonmember products did not exceed the value of the sales of member-produced products.[177]

This cooperative preserved its section 521 eligibility.[178] By virtue of the agency agreements between the member-agents and their respective producer-principals, who were not members of the cooperative, it was treating the nonmembers as patrons.[179] The nonmembers were legally entitled to share in the cooperative's net earnings on a pro rata patronage basis.[180] This cooperative, therefore, differed from the cooperative at issue in Revenue Ruling 67-152, where the nonmember producers were not treated as patrons.[181]

2. *Section 521 Implications for a Hypothetical Cooperative*

The implications of these decisions for a New Generation cooperative with "just investing" farmer-members can be illustrated by considering a hypothetical cooperative that processes durum wheat into pasta. All of the members of the cooperative are durum wheat producers. For reasons relating to convenience and the avoidance of direct storage costs, however, the members do not want to satisfy all of their delivery obligations using the production from their respective farms. Instead,

172. *Id.*
173. *Id.*
174. *Id.*
175. *Id.*
176. *Id.*
177. *Id.*
178. *Id.*
179. *Id.*
180. *Id.*
181. *Id.* The "look through" analysis used in Revenue Ruling 55-496 was followed in a private letter ruling involving a similar agency relationship. Priv. Ltr. Rul. 93-10-031 (Mar. 12, 1995). It also has been used in determining whether a federated cooperative is eligible for section 521. For a discussion of federated cooperatives and the "look through" analysis, see Frederick, *supra* note 119, at 72-76.

they would like to be able to obtain at least some of the durum wheat that they are obligated to deliver from another source.

Also assume that either the cooperative desires to assist its members in obtaining durum wheat from another source or that the members acting independently of the cooperative desire to find a means by which they can easily obtain wheat from another source. In either case, two options are under consideration. Under the first option, a third-party purchasing agency would be created or otherwise made available to the members for the purposes of buying durum wheat on the open market on behalf of the members who wanted to deliver purchased wheat. Some of the wheat thus acquired might be member-produced wheat, such as wheat produced by members in excess of their delivery obligations to the cooperative. Most of the wheat, however, likely will be wheat produced by nonmembers. Determining the true, original source of the wheat will be virtually impossible because wheat is a fungible commodity, and open market wheat is the commingled product of many producers.

The second option would be to create a "pool" consisting entirely of member-produced wheat that had been segregated and stored in various facilities in the area served by the cooperative. While it would be segregated from nonmember-produced wheat, the production from the members' farms would be commingled. Thus, none of the wheat, which is a fungible commodity, could be matched with its member-producer source.

This "pool" might operate in the following manner. Members could deliver any amount of their own production to the pool. Except for the assessment of storage, handling, and administrative fees, a member could withdraw without additional charge an amount equal to the amount of wheat the member delivered to the pool. If, however, the member delivered to the pool less than the amount withdrawn, an additional charge that represented the market value or other price of the wheat would be assessed. If a member delivered more wheat to the pool than the member withdrew from the pool, the member would be paid a price for the amount of wheat delivered in excess of the amount withdrawn. Title to the wheat in the pool could remain with the producers who delivered it to the pool, or it could be transferred to the entity operating the pool.

If the cooperative elected the first option, allowing or facilitating purchases by its members of open market wheat through a third-party purchasing agency, the cooperative would not be eligible for section 521 for at least two reasons. First, by processing purchased wheat the cooperative would violate the prohibition against marketing

non-producer products.[182] None of the cooperative's members would be "producers" with respect to the purchased wheat because they did not bear the risk of its production. Under the facts of the hypothetical, none of the exceptions to this prohibition would apply.

Second, irrespective of the value or quantity of the marketing of the purchased wheat relative to the value or quantity of the wheat delivered from the member's production, ineligibility would result from the inability of the cooperative to treat the producers of the purchased wheat as patrons.[183] Even if the cooperative wanted to treat those producers as patrons, it would be virtually impossible to do so because of the extraordinary difficulty or impossibility of identifying who produced the wheat obtained through the purchasing agency. Under this option, therefore, the cooperative would be ineligible for section 521.[184]

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182. I.R.C. § 521(b)(1)(A) (West 2000).

183. *Id.* § 521(b)(1).

184. Some of the tax consequences for members who deliver purchased commodities were addressed by the IRS in Technical Advice Memorandum 96-52-007 (Dec. 27, 1996). The taxpayer was a self-employed farmer who produced grain, but he used his own production to feed his livestock. *Id.* As a result, he did not have enough of his own grain to fulfill his delivery obligations to the cooperative. *Id.* To satisfy these obligations, he purchased grain grown by other producers as he had intended to do when he joined the cooperative. *Id.* He had joined the cooperative as an "investment" without having the capacity to raise enough grain to satisfy his delivery obligations to the cooperative. *Id.*

The cooperative paid the taxpayer a per-bushel price when the grain was delivered. *Id.* It also made an additional payment to the taxpayer for the value added to the grain. *Id.* These payments, which were referred to as the "value-added payments," were paid from the cooperative's net earnings from the sale of the processed product. *Id.* The taxpayer also received patronage dividends. *Id.*

At issue was the proper treatment of the value-added payments. *Id.* The cooperative did not treat these payments as patronage dividends. *Id.* The taxpayer reported them as long-term capital gains to the extent that he satisfied his delivery obligations with purchased grains. *Id.* Accordingly, pursuant to I.R.C. § 1402(a)(3)(A) (West 2000), he excluded them from his net earnings from self-employment. *Id.*

The IRS, however, determined that the value-added payments were ordinary income that should be included in computing the taxpayer's net earnings from self-employment. *Id.* Relying on *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988), the IRS premised its reasoning on the proposition that the taxpayer's investment motivation in purchasing an asset is irrelevant to the issue of whether the asset is a capital asset. *Id.* Instead, whether an asset is a capital asset is tested exclusively under section 1221 of the Code. *Id.*

The IRS reasoned that the value-added payments could be viewed as either in the nature of patronage dividends or as proceeds from the sale of property held primarily for sale to customers in the ordinary course of a trade or business. *Id.* Viewed either way, the payments would be ordinary income. *Id.*

The IRS deemed the taxpayer to be a grain grower because only growers could be members of the cooperative. *Id.* It then noted that the income a grower receives from marketing grain is ordinary income, and grain would not be a capital asset in the hands of a grower. *Id.* In the IRS's view, the fact that the grain marketed through the cooperative had been purchased from other sources while the grain grown by the taxpayer was fed to his cattle did not alter the fact that the taxpayer was a grain grower marketing grain that he grew. *Id.* It therefore concluded that the income realized from the marketing of that grain was ordinary income, and the value-added payment was simply an additional return from the marketing of that grain. *Id.*

The IRS also noted that I.R.C. § 1221(1) (West 2000) excludes from ordinary income property held primarily for sale to customers. *Id.* It then reasoned that if the taxpayer's transactions with the cooperative were a sale, the sole reason for the taxpayer's purchase of the grain was for resale

If the cooperative or its members elected the second option—the "pooling" of member-produced wheat—the cooperative might be eligible for section 521. All of the wheat delivered to the cooperative would be delivered by members who were wheat producers. All of the wheat processed by the cooperative would be member-produced wheat. The only uncertainty as to the source of the wheat would be the identity of the individual member or members who actually produced each shipment of wheat delivered from the pool.

Notwithstanding the inability to trace each delivery of wheat to the member who produced it, every producer of the wheat from the pool would be treated as patron because every producer of that wheat would be a cooperative member. Although a member might have sold to the pool more wheat than he or she was obligated to deliver to the cooperative, that member would be entitled only to a pro rata share of the cooperative's net earnings based on the amount of wheat he or she delivered to the cooperative, not the "pool."

In addition, the limitations on the value of nonmember products processed by the cooperative relative to the value of member products processed would appear not to apply. In Revenue Ruling 67-152 discussed previously,[185] the IRS ruled that products purchased by a cooperative's members from nonmember producers would be deemed "products of nonmembers" because they were produced by nonmembers.[186] In this hypothetical, however, the wheat acquired by the members from the pool would be the products of members, albeit not necessarily the member who made the acquisition.

The hypothetical cooperative's eligibility for section 521 would still be vulnerable, however. As to the wheat acquired from the pool, the members delivering it to the cooperative would not necessarily be the producers of that particular wheat. Assuming the pool operated for the members' convenience, none of the limited exceptions pertaining to the rule against a cooperative's processing of non-producer products would apply.

The degree of vulnerability is likely to depend on whether the members had delivered to the pool an amount equal to the amount they withdrew. In that case, given the fungible nature of wheat and the theoretical possibility that the wheat a member withdrew was the same wheat the member produced, members who withdrew the same amount they delivered could fairly be deemed to be the producers of that wheat.

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pursuant to his pre-existing agreement to deliver grain to the cooperative. *Id.* It also reasoned that the fact that the taxpayer had only one customer, the cooperative, was not inconsistent with a finding that the taxpayer was in the trade or business of selling grain. *Id.* Accordingly, income from such a trade or business would be ordinary income. *Id.*

185. *See supra* notes 152-65, and the accompanying text.

186. Rev. Rul. 67-152, 1967-1 C.B. 147, *superseding* I.T. 3853, 1947-1 C.B. 42.

Moreover, if the pool continuously operated on an "equal exchange" basis, each participant would indirectly bear the risk that one or more members might be unable to produce and deliver a sufficient amount of wheat to ensure that equal exchanges would always be possible. In this sense, a pool that operated on an equal exchange basis would represent a form of risk-sharing in the production of the members' wheat.

If, however, members withdrew from the pool more wheat than they delivered to the pool, the members could not be fairly deemed to be producers of the wheat withdrawn in excess of the amount delivered. In that case, the member would be a reseller of wheat, not a producer. Under the decision in *Dr. P. Phillips Cooperative v. Commissioner* discussed previously, a cooperative that markets or processes products delivered to it by members who are resellers of that product, instead of its producers, is not eligible for section 521[187].

In addition, the members would have acquired the wheat from a non-producer, the pool. The pool would not operate a farm or bear the risk of producing the wheat. It simply would facilitate the members' access to harvested wheat. But this would be true only if the pool acquired title to the wheat in the pool as opposed to serving as an agent for the members who delivered and withdrew wheat from the pool. If the title to the wheat in the pool was retained by the members who produced it, the pool would operate, in effect, as the venue for the exchange of wheat among the member-producers who participated in the pool. As discussed above, such an exchange is more likely to permit a cooperative to satisfy the requirements of section 521 if it operates on an "equal exchange" basis.

B. INTERNAL REVENUE CODE SUBCHAPTER T

While so-called "exempt" section 521 cooperatives are entitled to income tax deductions not available to "nonexempt" cooperatives, any corporation that desires to be taxed as a cooperative under Subchapter T of the Internal Revenue Code[188] must do business on a cooperative basis. The primary benefit offered to cooperatives by Subchapter T is "single-tax" treatment of their net earnings distributions to their patrons made in the form of patronage refunds or per-unit capital retain allocations.[189]

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187. *See supra* notes 134-38, and the accompanying text; *see also* Dr. P. Phillips Coop. v. Commissioner, 17 T.C. 1002 (1951).

188. I.R.C. §§ 1381-1388 (West 2000).

189. *Id.* The Internal Revenue Code uses the term "patronage dividends" instead of "patronage refunds" to describe these distributions. *Id.* § 1388(a).

Such distributions are taxed only once, either at the cooperative level or the patron level, depending on the manner of distribution.[190]

Neither the Code nor its implementing regulations define "operating on a cooperative basis." The Code's sparse language simply extends the benefits of Subchapter T to "any corporation operating on a cooperative basis."[191] The regulations repeat this phrase and add the following: "and allocating amounts to patrons on the basis of the business done with or for such patrons."[192] A "patron," according to the regulations, is "any person with or for whom the cooperative association does business on a cooperative basis, whether a member or nonmember of the cooperative association."[193]

In the absence of a statutory definition of the phrase "operating on a cooperative basis," the IRS and the courts have had to determine its meaning.[194] While neither has spoken the last word, articulations of the meaning of "operating on a cooperative basis" usually have been premised on one of two approaches.[195]

The first approach looks only to the Subchapter T rules, with a focus on how the entity's net earnings are distributed or how its per-unit retains are allocated.[196] Its rationale for not considering the overall organization and operation of the entity is that

> the essence of operation on a cooperative basis for tax purposes is contained in the requirements for patronage refund deductions. If the income to a cooperative is distributed to patrons as required by the Code, no further inquiry is needed

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190. *See generally* Donald A. Frederick & John D. Reilly, *Income Tax Treatment of Cooperatives: Patronage Refunds, in* USDA ACS INFORMATION REPORT 44, pt. 2 (Dec. 1993); Donald A Frederick & John D. Reilly, *Income Tax Treatment of Cooperatives: Distribution, Retains, Redemptions, and Patrons' Taxation, in* USDA ACS INFORMATION REPORT 44, pt. 3 (Dec. 1993).

191. I.R.C. § 1381(a)(2). It has been suggested that "[t]he fact that the Code provides that 'any corporation' can be a cooperative indicates an intent by Congress to accommodate within the scope of subchapter T the special nuances, regulatory requirements, financial arrangements, and other factors unique to a wide variety of industries." Donald A. Frederick & John D. Reilly, *Income Tax Treatment of Cooperatives: Background, in* USDA ACS INFORMATION REPORT 44, pt. 1, at 24 (Nov. 1993).

192. Treas. Reg. § 1.1381-1(a) (Apr. 2, 1963). This language excludes allocations based on the financial investments of patrons. *See* John E. Nokes, *Taxation of Agricultural Cooperatives, in* 14 NEIL E. HARL, AGRICULTURAL LAW § 135.01[2](b) (1996).

193. Treas. Reg. § 1.1388-1(e) (Apr. 2, 1963). The term "patron" is not defined in the Internal Revenue Code.

194. *See* Larry C. Boeshart et al., Principles of Cooperative Taxation 2 (1998) (noting that "although administrative and judicial interpretations have provided substantial guidance, certain issues remain with respect to the characterization of a corporation as a cooperative") (unpublished manuscript, on file with author).

195. James R. Baarda, Unites States Cooperatives and Income Tax Policy 125 (1997) (unpublished manuscript, on file with author).

196. *Id.*

> because that activity is operation on a cooperative basis by definition.[197]

This approach has found some support in the courts, but the IRS has not embraced it.[198]

The competing approach has been characterized as the "economic approach."[199] This approach takes "the 'operating on a cooperative basis' term as a general statement of principles to be determined by economic or operational rules established outside existing Code terminology."[200]

An early tax court decision addressing the meaning of "operating on a cooperative basis" reflects this approach.[201] In *Puget Sound Plywood v. Commissioner*,[202] the issue was whether a worker cooperative association in which each worker's labor constituted his or her patronage was a cooperative for federal income tax purposes.[203] In rejecting the IRS position that it was not, the court invoked the venerable Rochdale Principles[204] as the starting point for its analysis of the issue:

> The founders of the . . . Rochdale Cooperative formulated three guiding principles, which still persist as the core of economic cooperative theory: (1) Subordination of capital, both as regards control over the cooperative undertaking, and as regards the ownership of the pecuniary benefits arising

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197. *Id.* This approach is essentially encapsulated in the following statement: "[t]he only statutory limits to the benefit of qualifying as a cooperative, access to single tax treatment of patronage refunds and per-unit retains, are found in the definitions of a patronage refund (dividend) and per-unit retain allocation." Frederick & Reilly, *supra* note 191, at 24 (citing I.R.C. § 1388(a) & (f) (West 2000)).

198. *See* Baarda, *supra* note 195, at 150-51 (asserting that *Columbus Fruit & Vegetable Coop. v. United States*, 7 Cl. Ct. 561 (1985), and Conway County Farmers Ass'n v. United States, 588 F.2d 592 (8th Cir. 1978) "reject[] the idea that a corporation operating on a cooperative basis must meet organizational requirements and principles in addition to those imposed for specific deductions"). *But see* Frederick & Reilly, *supra* note 191, at 28 (citing these and other cases and stating:

> [w]hether these precedents will lead to an eventual determination that the only consideration needed in an "operating on a cooperative basis" inquiry is whether the patronage refunds or per-unit retains meet the definitional requirements of the Code is an issue whose final resolution is unlikely for some time to come.

Id.

199. Baarda, *supra* note 195, at 125.

200. *Id.*

201. *See* Puget Sound Plywood v. Commissioner, 44 T.C. 305 (1965).

202. 44 T.C. 305 (1965).

203. *Puget Sound*, 44 T.C. at 305.

204. *Id.* at 308. The Rochdale Principles were derived from the practices of the Rochdale Society of Equitable Pioneers formed in Rochdale, England, in the 1840s. *See* EWELL PAUL ROY, COOPERATIVES: DEVELOPMENT, PRINCIPLES AND MANAGEMENT 250 (4th ed. 1981). The Society was a consumer cooperative that sold clothing, food, and similar goods. *Id.* The Society's rules and practices became known as the "Rochdale Principles," and they eventually "crystallized into a code that most cooperators throughout the world came to accept." *Id.*

> therefrom; (2) democratic control by the worker-members themselves; and (3) the vesting in and the allocation among the worker-members of all fruits and increases arising from their cooperative endeavor (i.e., the excess of the operating revenues over the costs incurred in generating those revenues), in proportion to the worker-members' active participation in the cooperative endeavor.[205]

The court then applied these principles to the association at issue, concluding that they satisfied them.[206] The IRS subsequently acquiesced to the decision.[207]

The Rochdale principles referenced in *Puget Sound* have reappeared in IRS private letter rulings.[208] In 1993, the IRS announced in a public ruling that the cooperative principles set forth in *Puget Sound* provided the basis for determining whether a corporation was "operating on a cooperative basis."[209]

The IRS, however, has not limited itself to the Rochdale principles relied upon in *Puget Sound*. To the contrary, it has added more criteria.[210] Consequently, even a corporation that meets the *Puget Sound* principles may not be a cooperative under the IRS standard.[211] For example, in a private letter ruling, the IRS offered four additional factors that it contends should be considered:

> 4. Joint effort: The organization must be engaged in some joint effort actively with, for, or on behalf of its members.
> 5. Minimum number of patrons: There must be a minimum number of patrons; the organization must have sufficient

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205. *Puget Sound*, 44 T.C. at 308.

206. *Id.*

207. *See* 1966-2 C.B. 6 (listing revenue ruling decisions in which the Commissioner acquiesced).

208. *See* Baarda, *supra* note 195, at 131 n.316 *and* Frederick & Reilly, *supra* note 191, at 26 n.70 (collecting the letter rulings relying on *Puget Sound*). For example, in a 1992 private letter ruling, the IRS set forth three fundamental factors it believes are required by the *Puget Sound* decision:

> 1. Subordination of capital: The organization must limit the financial return it pays on its contributed capital.
> 2. Democratic control: Each member must have one vote regardless of the size of the member's investment or the amount of business the member does with the cooperative.
> 3. Operation at cost: At least annually, the organization must return the excess of its revenues over its related costs to its patrons in proportion to the volume or value of business done with each patron.

Dean, *supra* note 28, at 230 (quoting Priv. Ltr. Rul. 92-19-030 (Feb. 7, 1992)).

209. Rev. Rul. 93-21, 1993-1 C.B. 188.

210. For relatively complete collections of these criteria, in contexts ranging from voting to the allocation of losses, see Baarda, *supra* note 195, at 125-52, and McEowen & Harl, *supra* note 123, at A-18 to A-23.

211. Frederick & Reilly, *supra* note 191, at 26-28.

membership to form a "mutual joinder of interest" in the risks and benefits of the cooperative effort.
6. Limited business done with nonmembers: The amount of business done with nonmembers must be limited.
7. Liquidating distributions: Upon liquidation, present and former members must participate on a proportionate basis in any distribution of the organization's assets.[212]

On the other hand, the IRS occasionally has wholly or partially retreated from its own positions on what "operating on a cooperative basis" requires.[213] For example, though the IRS has contended that adherence to the one-member, one-vote principle is a requirement for Subchapter T eligibility, "this requirement has not been pursued as a criterion for operating on a cooperative basis."[214] Instead, the IRS more often relies on the more general "democratic control" principle as the standard, a standard that includes voting based on current patronage in addition to voting on a one-member, one-vote basis.[215]

Based on an approach that focuses only on the Subchapter T rules or based on one that goes beyond these rules to determine whether an enterprise is "operating on a cooperative basis," the "economic substance" of the transactions at issue is a central consideration.[216] For example, in *Mississippi Valley Portland Cement Co. v. United States,*[217] the issue was whether the cooperative was entitled to a deduction for

212. Dean, *supra* note 28, at 230-31 (quoting Priv. Ltr. Rul. 92-19-030 (Feb. 7, 1992)); *see also* Frederick & Reilly, *supra* note 191, at 26 (discussing these "additional factors").

213. The courts also have forestalled IRS efforts to impose requirements for which there is no statutory authority. *See, e.g.*, Conway County Farmers Ass'n v. United States, 588 F.2d 592 (8th Cir. 1978) *and* Columbus Fruit & Vegetable Coop. Ass'n v. United States, 7 Cl. Ct. 561 (1985) (rejecting the IRS position that non-section 521 cooperatives must do more business with members than non-members). There are "other court decisions which are critical of the I.R.S. for reading into statutes applicable to cooperatives limitations or requirements not specifically set forth in the law." Nokes, *supra* note 192, § 135.01[2][b][ii] (citing, as among other examples, Associated Milk Producers, Inc. v. Commissioner, 68 T.C. 729 (1977), and Peninsula Light Co., Inc. v. United States, 552 F.2d 878 (9th Cir. 1977)). The IRS has taken a narrow view of Subchapter T generally, with limited success. *See, e.g.*, Daniel S. Welytok, *Doing Business as a Cooperative in the Face of Increased Challenges from IRS*, 84 J. TAX'N 37, 37 (1996) (observing that "[a]lthough the Service has been generally unsuccessful in its attempt to restrict the tax benefits of cooperatives, principally the conduit-like treatment that subjects patronage dividends to a single tax, it shows no signs of giving up").

214. Baarda, *supra* note 195, at 134; *see also* Nokes, *supra* note 192, § 135.01[2][b][iii] (noting that the Code does not impose a one-member, one-vote requirement).

215. Baarda, *supra* note 195, at 134-35 *and* McEowen & Harl, *supra* note 123, at A-5, A-18 (discussing the IRS position on one person, one vote as a criterion of "operating on a cooperative basis").

216. "Economic substance" is a term drawn from the statement in *Land O'Lakes, Inc. v. United States*, 514 F.2d 134, 139 (8th Cir. 1975) and used by Baarda to demonstrate that "[t]ax liability, or exemption therefrom, depends on the substance and not the form or name of a transaction or event." Baarda, *supra* note 195, at 145.

217. 408 F.2d 827 (5th Cir. 1969).

distributions it characterized as patronage dividends.[218] The cooperative had been organized to manufacture and sell cement.[219] It had issued close to two million shares of stock, about one-half of which were issued to eight individuals, their friends, relatives, and employees.[220] The principal shareholders were engaged in various trades and professions, ranging from automobile sales to accounting.[221]

Each shareholder was entitled to a "preferred patronage right" to purchase cement each fiscal year on the basis of one barrel of cement for each five shares owned.[222] Any cement purchased under these preferential rights would be sold at the prevailing market price.[223] However, if this price exceeded the cooperative's costs, patronage refunds would be paid annually in an amount proportional to the amount of cement allocated by the preferred patronage rights of each shareholder or his or her assignee.[224]

The cooperative's organizational documents permitted its board to allocate the cooperative's cement production to its shareholders and their assigns.[225] They also permitted the board to assign, on behalf of the shareholders, all of the cement not purchased by its shareholders to another cooperative that had been organized as the cement cooperative's sales agency.[226] This sales agency, in turn, sold the cement to the general public.[227]

For the period at issue and pursuant to resolutions of the cooperative's board, all of the cement produced by the cooperative was allocated to its shareholders and assigned to the sales agency.[228] Thereafter, the cement was sold to the general public.[229] The net proceeds were then distributed to the cooperative's shareholders in proportion to their stock ownership.[230]

The sale of all of the cement to the general public was the norm, not the exception.[231] As the court observed, "instances of shareholder-patrons actually taking cement from the plant were almost non-existent

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218. *Portland Cement*, 408 F.2d at 830-31.
219. *Id.* at 829.
220. *Id.* at 828-29.
221. *Id.* at 834.
222. *Id.* at 829.
223. *Id.*
224. *Id.*
225. *Id.*
226. *Id.*
227. *Id.* at 829-30.
228. *Id.*
229. *Id.*
230. *Id.* at 830.
231. *Id.* at 832

and virtually all of the cement was assigned to the sales agency."[232] The court also noted that, "generally speaking, the stockholder-patrons never had any actual use for or contact with the product of their corporation. The closest they came to the cement was to receive a right to X-number of barrels of cement which was semi-automatically assigned to a sales agency."[233]

The court denied the deduction, expressly premising its decision on the "economic substance" of the transactions before it.[234] As the court stated, "[w]e have lifted the cooperative veil and have unmasked the economic realities of these transactions."[235]

Assessing the transactions between the cooperative and its shareholders based on their economic substance, the court concluded that "the taxpayer's shareholders were no more than paper patrons, and 'that the distribution to stockholders was nothing more than a dividend paid out of profits of the corporation.'"[236] These shareholders, according to the court, "were merely investors and non-essential links in a conduit to the outside, not consumers of the corporate product."[237]

Characterizing the shareholders as "pseudo-patrons," the court identified two factors that it considered "particularly elucidative of the true nature of the distributions."[238] First, as revealed by the cooperative's organizational documents and the board's actions,

> the corporate purpose was not to supply its shareholders with cement at reduced cost but to supply them with a return on their invested capital. Although they contained words which allocated the cement in kind, the resolutions had the practical

232. *Id.*

233. *Id.* Under the Code, a "patronage dividend" must be paid to a patron "on the basis of quantity or value of business done with or for such patron." I.R.C. § 1388(a)(1) (West 2000). The IRS argued that the words "with or for" meant that a patron "must physically handle the products of the cooperative." Miss. Valley Portland Cement Co., v. United States, 408 F.2d 827, 832 (5th Cir. 1969). The court, while declining to find the absence of patron contact with the cement to be decisive, noted that

> in most bona fide cooperative arrangements the patron does in some manner actually touch the subject matter of the transactions. For example, a marketing cooperative usually sells to the general public commodities or products of the patron, and a purchasing cooperative usually purchases items to be used or consumed by the patron. Extending the syllogism, a manufacturing cooperative should usually, but not always, consume or otherwise physically use the product of the cooperative. Thus, evidence that the patron actually used the product points logically to the conclusion that the business was conducted "with or for" such patron. Conversely, the absence of such evidence would support, but not compel, a conclusion to the contrary.

Id. (citations omitted).

234. *Portland Cement*, 408 F.2d at 833 n.11.

235. *Id.* at 833.

236. *Id.* at 834 (quoting Peoples Gin Co. v. Commissioner, 118 F.2d 72, 73 (5th Cir. 1941)).

237. *Id.*

238. *Id.*

effect of both channeling the cement to its ultimate consumers and declaring a dividend on the basis of such sales. These allocations were phantoms, and the shareholders were pseudo-purchasers. Thus, the true measure of the so-called patronage dividend was not how much cement the paper patron consumed, but rather how much the taxpayer earned by selling to others.[239]

The second factor relied on by the court was "the absence of horizontal similitude among the stockholder-patrons."[240] Noting that "[i]n the usual manufacturing cooperative situation, the patrons have a fraternal commercial relationship with respect to the business of the cooperative and its products other than as investors," the court observed the situation at issue to be as follows:

In the case of a cement manufacturing cooperative it would be logical to expect that its patrons would be contractors, builders, and others [in] related occupations. Here, however, the businesses and professions of the principal shareholders are diverse: accounting, law, automobiles, construction, engineering, public relations and textiles. It would be a travesty to regard this variegated and disparate conglomerate of shareholders as being cement oriented and connected. The only thing these shareholders had in common was an investment in what they hoped would be a money making venture, and in this respect their relationship to each other and to the corporation was no different from that of shareholders in any other publicly held corporation.[241]

The court concluded that the patron-cooperative relationship before it was a "deficient patron-cooperative relationship" for there was no economic substance to a member's "patronage" of the cooperative.[242] Instead, the economic substance of the relationship flowed from the shareholders' capital investment.[243] Since virtually none of the shareholders actually used the cement manufactured by the cooperative; there was, in fact, virtually no patronage at all by any meaningful measure.[244]

239. *Id.*
240. *Id.*
241. *Id.*
242. *See* Baarda, *supra* note195, at 147.
243. *Id.*
244. *Id.*

The corporation was not, therefore, "operating on a cooperative basis."[245]

The economic substance of the enterprise was also determinative in Revenue Ruling 82-51,[246] which relied on *Mississippi Valley Portland Cement Co.*[247] The taxpayer was engaged in an integrated poultry operation.[248] The taxpayer had been organized as a non-section 521 cooperative by seven individuals who transferred to the cooperative their previously separate poultry raising assets.[249] In return, they received common stock issued by the taxpayer.[250] Thereafter, the members did not actively engage in poultry production relative to the functions carried out by the taxpayer.[251]

The taxpayer's members purchased chicks from the taxpayer's breeder stock.[252] These purchases were in proportion to each member's respective stockholdings.[253] Once sold by the taxpayer to the members, the chicks were segregated and identified according to the member who held title to them.[254] With the risk of their loss borne by the members, the chicks were then delivered to independent contractors who had "grow-out" contracts with the taxpayer.[255]

Under these "grow out" contracts, the taxpayer furnished the contract growers with the feed and medicine required by the chicks.[256] It also paid the contract growers for their services.[257] All of these payments were charged, at cost, to the accounts of its members.[258] When the chickens were ready for marketing, the taxpayer repurchased them from the members at their current market price.[259] It then processed and sold them.[260]

Following the sale of the chickens, each member received a settlement sheet showing the total sales price, offset by the amount of advances charged to the member's account in connection with the costs

245. *See* Nokes, *supra* note 192, § 135.01[2][b][i] *and* Baarda, *supra* note 195, at 147 (discussing the *Miss. Valley Portland Cement Co.* decision).

246. Rev. Rul. 82-51, 1982-1 C.B. 117.

247. *Id.*

248. *Id.*

249. *Id.*

250. *Id.*

251. *Id.*

252. *Id.*

253. *Id.*

254. *Id.*

255. *Id.*

256. *Id.*

257. *Id.*

258. *Id.*

259. *Id.*

260. *Id.*

of raising the member's particular flock.[261] If the settlement sheet reflected a profit, the gain was applied to offset advances made by the taxpayer on the member's account for the next flock of chickens.[262] Any losses suffered by the taxpayer were allocated on a patronage basis and used to offset any profits in the next grow-out period.[263] The taxpayer had never paid a patronage dividend to its members.[264]

The IRS ruled that the taxpayer was not operating on a cooperative basis.[265] Concluding that this case and the *Mississippi Valley Portland Cement Co.* case were substantially similar, the IRS focused on the economic substance of the transactions between the taxpayer and its members.[266] It found that the sales of chicks by the taxpayer to its members lacked economic substance.[267] The members took no action with respect to the chicks at any stage of their production or processing, nor did they consume the taxpayer's products.[268] They were merely "nonessential links" to the outside.[269]

Instead of functioning as a cooperative, the IRS concluded, the taxpayer's method of doing business was "indistinguishable from the normal corporation doing business for profit."[270] Consequently, any distributions to the member-shareholders were "merely dividends paid to its shareholders."[271]

An application of the reasoning of the court in *Mississippi Valley Portland Cement Co.* and the reasoning of the IRS in Revenue Ruling 82-51 to a cooperative whose membership substantially consisted of "just investing" farmers could lead to the conclusion that the cooperative was not "operating on a cooperative basis."[272] Reaching this conclusion is likely to depend on whether the "just investing" farmer-members purchased the commodity on the open market or obtained it from a "pool" consisting of member-produced product.

Members who delivered commodities purchased on the open market through a purchasing agency or otherwise would be participating in

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261. *Id.*
262. *Id.*
263. *Id.*
264. *Id.*
265. *Id.*
266. *Id.*
267. *Id.*
268. *Id.*
269. *Id.* at 118.
270. *Id.*
271. *Id.*
272. *See* Mississippi Valley Portland Cement Co. v. United States, 408 F.2d 827, 835 (5th Cir. 1969) (concluding the shareholders were not patrons "and they had no commercial fraternal relationship other than as investors") *and* Rev. Rul. 82-51, 1982-1 C.B. 117, 118 (reasoning that the business was indistinguishable from a corporation and the distributions were dividends).

the cooperative on a cash basis. While they are likely to be farmers, they would not be delivering their own production.[273] Other than qualifying them for cooperative membership, their status as farmers would be irrelevant.[274] In economic substance, the members would be participating in the cooperative not as farmers but as commodity purchasers and sellers.[275]

Moreover, the members who delivered purchase commodities would be "nonessential links" from the cooperative to the outside.[276] They would be doing for the cooperative what it could do for itself with the members cash–purchasing the commodity on the open market.

Finally, the economic substance of any "value-added" return on the purchased commodity would be the same as that of a dividend on an equity investment in the cooperative. While the amount of the return would be based on the quantity of the commodity delivered, that quantity would be only a surrogate for the cash used to acquire it. Any value-added return, therefore, would be a return on this cash investment.[277] Accordingly, the relationship between the cooperative and its "just investing" farmer-members would be indistinguishable from the relationship between an ordinary corporation and its shareholders.[278] As the reasoning in *Mississippi Valley Portland Cement Company* and Revenue Ruling 82-51 reveals, a cooperative with such a relationship with its members is not "operating on a cooperative basis."[279]

The result might be different if the commodity delivered came from a "pool" consisting of the commingled, fungible production of a cooperative's members. All of the commodity delivered to the cooperative in this instance would have been produced by the "at risk" labor and management of the cooperative's members, even if each member did not actually produce the specific units of the commodity he or she delivered. In addition, the members would be "essential links" to the outside because the cooperative would depend solely on the members' production of the commodity for its supply of that commodity. Accordingly, any value-added return received by the members would be

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273. *Cf.* Rev. Rul. 82-51, 1982-1 C.B. at 118 (receiving the grown chickens from the contract growers, not from the member/owners).

274. *See id.*

275. *See id.*

276. *Cf. id.* (being nonessential because the contract grower, not the member/owner, delivered the product to the cooperative).

277. *Id.*

278. *Id.*

279. *See* Mississippi Valley Portland Cement Co. v. United States, 408 F.2d 827, 835 (5th Cir. 1969)

attributable to their efforts as producers of the commodity as opposed to their mere investment of cash.

Only if the pool operated on an "equal exchange" basis would all of the members be participating exclusively as producers. If some members needed more units of the commodity from the pool than they delivered to it to fulfill their delivery obligations, their purchases from the pool would relegate them to the status of a mere investor in the cooperative as to the purchased units. Thus, to the extent the cooperative did business with these members, it would not be "operating on a cooperative basis."

A New Generation cooperative that found itself not operating on a cooperative basis because of the presence of "just investing" farmers in its membership would have to convert to a limited liability company (LLC) if it desired to retain the benefit of single-taxation.[280] Minnesota Corn Processors, formerly a Minnesota New Generation cooperative, made such a conversion by merging with a Colorado LLC created for the purpose of converting the cooperative to LLC status after concluding that it was likely to lose its single-tax status as a cooperative because of its "just investing" farmer members.[281]

C. THE FEDERAL SECURITIES LAWS

The Securities Act of 1933[282] and the Securities Exchange Act of 1934[283] are the principal federal securities laws. Broadly distinguished, the 1933 Act regulates the initial sale of securities, and the 1934 Act regulates the public trading of securities on the national security exchanges and over-the-counter trading.[284] Both statutes share the general objectives of requiring disclosure to investors of material information concerning public securities offerings and preventing misrepresentation, deceit, and other fraud in securities sales.

The registration of initial public offerings of securities is required by the 1933 Act.[285] Registration "is [intended] to protect investors by promoting full disclosure of information thought necessary to informed

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280. Under the so-called "check-the-box" Treasury regulations, Treas. Reg. § 301.7701-1 to -3 (1967), limited liability companies are generally eligible for single-taxation treatment at the member level.

281. *See* Information Statement–Prospectus Relating to the Conversion of Minnesota Corn Processors, Inc., to a Colorado limited liability company (Jan. 6, 2000) at 12, *available at* http://www.sec.gov/Archives/edgar/data/1077133/0000897101-00-000014-index.html.

282. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77bbbb (1994 & Supp. V 1999)).

283. Securities Act of 1934, ch. 404, 48 Stat. 88 (codified as amended at 15 U.S.C. §§ 78a-78*ll* (1994 & Supp. V 1999)).

284. *Compare* 15 U.S.C. §§ 77a-77bbbb *with* 15 U.S.C. §§ 78a-78*ll*.

285. 15 U.S.C. §§ 77e-77f.

investment decisions."[286] If an investment meets the definition of a "security" and no exemption from registration applies,[287] it must be registered with the Securities and Exchange Commission (SEC) before it can be sold.[288] The registration statement requires truthful disclosure of financial and other information about the organization issuing the security.[289] A prospectus containing material financial and other information also must be given to all prospective investors.[290] Even if an exemption from registration applies, the offer and sale of the security is subject to the Act's anti-fraud provisions.[291]

Registration can be costly.[292] In addition to indirect costs such as those that flow from the delays that registration can entail,[293] the direct costs, including the legal and accounting fees, "associated with the preparation of the registration statement could total from $200,000 to $500,000."[294]

New Generation cooperatives usually prefer to avoid these costs either by securing the exemption available to I.R.C. § 521 cooperatives or by avoiding the issuance of a security. Cooperatives that elect the former option must contend with the strictures of section 521.[295]

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286. C. Steven Bradford, *Transaction Exemptions in the Securities Act of 1933: An Economic Analysis*, 45 EMORY L. J. 591, 599 (1996) (quoting SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953)).

287. The exemptions fall within two categories: transactional exemptions and securities exempted from registration. The Securities Act of 1933 exempts from the registration requirements the securities issued by a section 521 cooperative. 15 U.S.C. § 77c(a)(5)(B). An exemption from the registration requirements under the Securities Exchange Act of 1934 for securities traded over-the-counter applies to "cooperative associations" as defined in the Agricultural Marketing Act of 1929. 12 U.S.C. § 1141j(a) (1994). Under the Agricultural Marketing Act of 1929, a "cooperative association" is a farmer marketing or supply cooperative that operates "for the mutual benefit of the members thereof as such producers or purchasers" on either a one member, one vote basis or does not pay "dividends . . . in excess of 8 per centum per annum" and does more business with members than nonmembers, excluding business done with the United States. *Id.* This exemption does not encompass the requirements of the 1934 Act pertaining to brokers, dealers, or exchanges. *See* 15 U.S.C. § 78c(a)(1), (4), (5) (laying out the parameters for exchange, broker, and dealer).

State securities laws may apply to securities issued by cooperatives. However, in many states complete or partial exemptions apply to farmer cooperatives. *See generally* James R. Baarda, *State Security Law Exemptions for Farmer Cooperatives*, *in* USDA ACS STAFF REPORT (Nov. 1984).

288. 15 U.S.C. § 77f.

289. *Id.*

290. *Id.*

291. *See generally* John E. Nokes, *Agricultural Cooperative Securities*, *in* 14 NEIL E. HARL, AGRICULTURAL LAW § 136.02[4] (1996); Kathleen M. Graber et al., *Securities Fraud*, 30 AM. CRIM. L. REV. 909 (1993). The consequences of offering or selling unregistered securities include possible criminal liability. *See* 15 U.S.C. § 77f. The more likely consequences, however, involve civil liabilities, including rescission of the sale. *See id.* §§ 77l, 77p(a).

292. Bradford, *supra* note 286, at 605-10.

293. *Id.*

294. *Id.* at 603. Some of the costs, however, might have been incurred even if the offering was not registered. *Id.*

295. *See supra* Part V.A.

Cooperatives that elect the latter option must contend with the uncertainties in the definition of a "security."

The 1933 and 1934 Acts broadly define the term "security"[296] in nearly identical terms.[297] Under these definitions, "unless the context otherwise requires,"[298] a "security" can be any one of a variety of instruments or transactions, such as any note, stock, bond, debenture, investment contract, and "any interest or instrument commonly known as a 'security.'"[299] Because the terms within the definitions are not themselves defined, the task of defining them has been assumed by the courts and the SEC.

"Stock" is listed in the statutory definition of a "security."[300] A membership interest in a cooperative is often evidenced by membership stock.[301] Nonetheless, membership stock in a traditional cooperative is generally not considered to be a security for the reasons articulated by the Supreme Court in *United Housing Foundation, Inc. v. Forman*.[302] There the Court rejected the notion that any instrument called "stock" must be considered a security simply because the Security Act of 1933 defines "security" to include "any . . . stock."[303] Rather, the Court adhered to what it characterized as "the basic principle that has guided all of the Court's decisions in this area"[304] by disregarding form in favor of substance and placing the emphasis on "economic reality."[305]

At issue in *Forman* was whether stock issued by a nonprofit housing cooperative was a "security" within the meaning of the 1933 and 1934 Securities Acts.[306] The cooperative operated a large housing project in New York City known as Co-op City that had been built with state

296. 15 U.S.C. §§ 77b(a)(1) (Securities Act of 1933) *and* 78c(a)(10) (Securities Exchange Act of 1934).

297. *See* Reves v. Ernst & Young, 494 U.S. 56, 61 n.1 (1990).

298. 15 U.S.C. §§ 77b(a), 78c(a). For an extended discussion of the meaning of this phrase, which precedes all of the definitions in both Acts, see Lewis D. Lowenfels & Alan R. Bromberg, *What is a Security Under the Federal Securities Laws?*, 56 ALB. L. REV. 473, 483-89 (1993).

299. 15 U.S.C. §§ 77b(a)(1), 78c(a)(10).

300. *See id.*

301. *See* 12 U.S.C. § 1141j(a) (1994).

302. 421 U.S. 837 (1975).

303. *United Housing*, 421 U.S. at 848.

304. *Id.*

305. *Id.* (quoting Tcherepnin v. Knight, 389 U.S. 332, 336 (1967)). Although the Court ruled that the name given to an instrument is not dispositive of whether the instrument is a "security," it also indicated that the name is not wholly irrelevant. *Id.* at 850. In this regard, the Court observed that "[t]here may be occasions when the use of a traditional name such as 'stocks' or 'bonds' will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument." *Id.* at 850-51.

306. *Id.* at 840-41.

subsidies under a program designed to promote the availability of housing for low income persons.[307]

A prospective tenant had to buy eighteen shares in the cooperative for each room desired.[308] These shares did not confer voting rights and their transferability was limited.[309] Tenants who terminated their tenancy or who were evicted had to offer their stock to the cooperative at its initial price of $25 per share.[310] If the cooperative did not repurchase the stock, although this was unlikely, the tenant could not "sell it for more than the initial purchase price plus a fraction of the portion of the mortgage that he ha[d] paid off, and then only to a prospective tenant satisfying the statutory income eligibility requirements."[311]

The Court held that the stock, as such, was not a "security" under the 1933 and 1934 Acts.[312] In addition to noting the absence of any contention that the tenants had been, or could be, misled into believing that federal securities law governed the sale of the stock simply because the stock was called "stock,"[313] the Court concluded the stock was not the type of instrument that fit within the ordinary concept of a security.[314] The stock lacked "the most common feature of stock: the right to receive 'dividends contingent on an apportionment of profits.'"[315] It also did not "possess the other characteristics traditionally associated with stock" in that it was not negotiable; it could not be pledged or hypothecated; it did not confer voting rights in proportion to the number of shares owned; and it could not appreciate in value.[316]

The Court also addressed the question of whether the stock was an "investment contract" within the meaning of the 1933 and 1934 Acts.[317] It prefaced its analysis by observing that, in its view, there was "no distinction, for present purposes, between an 'investment contract' and an 'instrument commonly known as a security.'"[318] Drawing from

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307. *Id.*

308. *Id.* at 842.

309. *Id.* at 842-43.

310. *Id.*

311. *Id.*

312. *Id.* at 859-60.

313. *Id.* at 851.

314. *Id.* In *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 (1985), the Court described the characteristics traditionally associated with common stock as follows: "(i) the right to receive dividends contingent upon an apportionment of profits; (ii) negotiability; (iii) the ability to be pledged or hypothecated; (iv) the conferring of voting rights in proportion to the number of shares owned; and (v) the capacity to appreciate in value." *Accord* Gould v. Ruefenacht, 471 U.S. 701, 704-06 (1985).

315. United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851 (1975) (quoting Tcherepnin v. Knight, 389 U.S. 332, 339 (1967)).

316. *Id.*

317. *Id.*

318. *Id.* at 852.

its decision in *SEC v. W. J. Howey Co.*,[319] the Court observed that both investment contracts and securities are distinguished from other commercial transactions by the basic test of "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[320] This test, according to the Court, "embodies the essential attributes that run through all of the Court's decisions defining a security. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."[321]

The Court then observed that in the cases where it had concluded that the instrument at issue was a security, the investor was "'attracted solely by the prospects of a return' on his investment."[322] It contrasted this motivation for acquiring an instrument with one where the motivation and the instrument are linked to the right to use or consume something: "when a purchaser is motivated by a desire to use or consume the item purchased—'to occupy the land or to develop it themselves,' as the *Howey* Court put it,—the securities laws do not apply."[323]

The Court in *Forman* concluded that the stock issued by the cooperative was not an investment contract because its acquisition was motivated by a desire for housing, not for a return on an investment.[324] It also noted that the cooperative operated on a nonprofit basis by returning rental payments in excess of its costs to the tenants as rebates.[325] It did not invest that excess for profit.[326] Moreover, tenants could not sell their stock at a profit because the stock had to be first offered back to the cooperative at its purchase price.[327]

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319. 328 U.S. 293 (1946).
320. *Forman*, 421 U.S. at 852 (quoting *Howey*, 328 U.S. at 301).
321. *Id.*
322. *Id.* (quoting *Howey*, 328 U.S. at 300).
323. *Id.* at 852-53 (citation omitted).
324. *Id.* at 859.
325. *Id.* at 854.
326. *Id.*
327. *Id.* The Court "summarily" disposed of "[t]wo . . . supposed sources of income or profits" that had been relied on by the court below. *Id.* at 855. The first source was the gain represented by an income tax deduction that stockholder-tenants received for the portion of the monthly rental charge applied to interest on the mortgage. *Id.* The Court, however, found "no basis in law for the view that the payment of interest, with its consequent deductibility for tax purposes, constitutes income or profits." *Id.* The Court added that even if they were profits "they would not be the type associated with a security investment since they do not result from the managerial efforts of others." *Id.* n.20. The Court found that the subsidized rent was not profit because the subsidies could not be liquidated into cash, and they did not result from the managerial efforts of others. *Id.* at 855. It also disagreed with the lower court that the possibility of profits from the cooperative's leasing of commercial facilities, offices, and parking areas and its operation of washing machines was enough to make the stock an investment contract. *Id.* at 855-56. In the Court's view, these "stores and services . . . were established not as a means of returning profits to tenants, but for the purpose of making essential

Conceding that the "purchasers in this housing cooperative sought to obtain a decent home at an attractive price," the Court found that this "type of economic interest characterizes every form of commercial dealing."[328] It added, in summation, "[w]hat distinguishes a security transaction—and what is absent here—is an investment where one parts with his money in the hope of receiving profits from the efforts of others, and not where he purchases a commodity for personal consumption or living quarters for personal use."[329]

The *Forman* Court's reliance on its decision in *Howey* reflects the fact that much of the litigation over the scope of the definition of a "security" has involved the meaning of the term "investment contract."[330] As a result, this term has become "a paradigm of the Securities Act's inclusiveness."[331]

In *Howey*, the Court ruled that

> an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.[332]

This definition, according to the Court, "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[333]

Notwithstanding the *Howey* Court's definition of an investment contract as a scheme involving the investment of money in a common enterprise with profits coming *solely* from the efforts of others, lower courts have found transactions to be investment contracts where the profit was not derived solely from the efforts of others.[334] For example, in *SEC v. Glenn W. Turner Enterprises, Inc.*[335] the Ninth Circuit held that certain arrangements sold under a pyramid scheme were investment contracts even though some of the profits came from the efforts of purchasers of these plans to find additional purchasers.[336] It ruled that the term

services available for the residents of this enormous complex." *Id.* at 857.

328. *Id.* at 858.

329. *Id.*

330. *See id.* at 851-52.

331. LARRY D. SODERQUIST & THERESA A. GABALDON, SECURITIES REGULATION 128 (4th ed. 1999).

332. SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946).

333. *Id.* at 299.

334. *See* discussion *infra* notes 335-39 and accompanying text.

335. 474 F.2d 476 (9th Cir. 1973).

336. *Turner*, 474 F.2d at 483.

"solely" should not serve to limit the definition of an investment contract; otherwise, the federal securities laws could be evaded by a scheme that required "the buyer [to] contribute a modicum of effort" to the success of the enterprise.[337] The Ninth Circuit, therefore, reformed the test for an investment contract to require an inquiry into "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[338] This test was subsequently followed by the Fifth Circuit.[339]

The Court's decisions in *Forman* and *Howey* and numerous lower court decisions reflect, in addressing the meaning of the term "security," the number of considerations involved make "determining whether or not a particular instrument is a 'security' within the 1933 and 1934 Acts' definitions . . . more of an art than a science."[340] With respect to farmer cooperatives, however, *Forman* is generally regarded as supporting the proposition that a farmer cooperative's membership stock is not a "security," at least if the stock has the attributes possessed by the housing cooperative stock at issue in that decision.[341] For example, in *B. Rosenberg & Sons, Inc. v. St. James Sugar Cooperative, Inc.*,[342] the issue was whether a share of common stock in a sugar cooperative was a security.[343] Each member of the cooperative was required to purchase one share of common stock.[344] The stock was not negotiable, bore no dividends, and entitled its holder to one vote in the affairs of the cooperative.[345]

The court held that the stock was not a security, relying in part on *Forman*.[346] It concluded that the stock simply signified membership in

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337. *Id.* at 482.
338. *Id.*
339. SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 479-81 (5th Cir. 1974). The test adopted by the Ninth and Fifth Circuits has been described as testing the common enterprise for broad, as opposed to strict, vertical commonality because it "requires only that the fortunes of the investor be linked to the *efforts* of the promoter or a third party" rather than requiring "that the fortunes of the investor be linked to the *fortunes* of the promoter or some third party." SODERQUIST & GABALDON, *supra* note 331, at 144-45. The Second Circuit, on the other hand, has ruled that broad vertical commonality is not enough. Revak v. SEC Realty Corp., 18 F.3d 81, 87 (2d Cir. 1994). In *Revak*, the Second Circuit ruled that a common enterprise can be shown with proof of horizontal commonality, which consists of a tying of each investor together through "a sharing or pooling of funds." *Id.* (quoting Hart v. Pulte Homes of Mich. Corp., 735 F.2d 1001, 1004 (6th Cir. 1984)). *See generally* Kyle M. Globerman, *The Elusive and Changing Definition of a Security: One Test Fits All*, 51 FLA. L. REV. 271, 286-88 (1999) (discussing the "common enterprise" test of *Howey*).
340. Lowenfels & Bromberg, *supra* note 298, at 560.
341. *See generally* United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975).
342. 447 F. Supp. 1 (D.C. La. 1976).
343. *Rosenberg*, 447 F. Supp. at 3.
344. *Id.*
345. *Id.*
346. *Id.* at 4.

the cooperative.[347] It had, in the words of the court, "none of the characteristics associated with the concept of a security. It is non-negotiable, bears no dividends, can only be owned by a member and can only be transferred with approval of the board of directors."[348]

The court also found that the stock was not an "investment contract."[349] In that context, it ruled that "[e]quity credits or patronage dividends are not profits similar to income from ordinary stock investments but are rebates or refunds to members based solely on patronage and not on the amount of money invested in the stock."[350] Moreover, according to the court,

> [i]t is readily apparent that local sugar cane farmers purchasing shares of stock in the defendant cooperative did not believe that they were purchasing investment securities. The inducement to purchase was membership in an association that would provide the sugar cane farmer with services he might not otherwise obtain[;] that is, the assurance of a place to process and market the fruits of his labor. The cooperative member did not participate for the purpose of obtaining profits from investment securities.[351]

Forman was relied upon by the Eighth Circuit in its decision in *Great Rivers Coop. of Southeastern Iowa v. Farmland Industries, Inc.*[352] There, certain equities known as "capital credits" were at issue.[353] The equities were held by inactive members of Farmland Industries, Inc., a farmer cooperative, as the result of the conversion of the members' common stock in Farmland, the exchange of equity from one entity to another, or as patronage refunds.[354] The court held that they were not "securities" under the federal securities acts.[355]

The plaintiffs contended in *Farmland Industries* that the capital credits were securities either under the family resemblance test set forth in *Reves v. Ernst & Young*[356] or the investment contracts test established

347. *Id.* at 3.
348. *Id.*
349. *Id.* at 4.
350. *Id.*
351. *Id.*
352. 198 F.3d 685 (8th Cir. 1999).
353. *Farmland Indus.*, 198 F.3d at 692.
354. *Id.* at 690-91.
355. *Id.* at 701. Farmland capital credits also were the subject of securities fraud litigation in Colorado, where they were held to be a "security." Consumers Gas & Oil, Inc. v. Farmland Indus., Inc., 815 F. Supp. 1403, 1410 (D. Colo. 1992); *see also* Consumers Gas & Oil, Inc. v. Farmland Indus., Inc., 840 F. Supp. 794 (D. Colo. 1993) (approving settlement order).
356. 494 U.S. 56, 61 (1990).

in *SEC v. W.J. Howey Co.*[357] In rejecting this contention, the court noted that the capital credits were received by the plaintiffs as a result of the conversion of their membership common stock in Farmland, the exchange of membership stock or retained equity from one Farmland-owned entity to another, or as patronage refunds.[358]

Therefore, the court reasoned, the capital credits represented "equity interests [in Farmland] that were initially obtained as an incident of membership in [Farmland]."[359] As incidents of this member-cooperative relationship, the capital credits had never been offered for sale by Farmland to its members or the general public.[360] They were transferable only with Farmland's consent and had no secondary market.[361] They neither bore interest, appreciated, nor could they be readily converted to cash.[362] Their only value resided in their future redemption by Farmland, at its board's discretion, at their face amount.[363] They did not, therefore, represent an investment of money in the traditional sense; that is, the investment of capital with the reasonable expectation of a return on that investment.[364] Instead, the court concluded, the capital credits represented the equity remaining in Farmland by persons who had earlier patronized Farmland to gain the benefits of that patronage.[365] In economic substance, the capital credits were not securities but were "patronage refunds or equity interests reflecting a membership or former membership in [Farmland] and/or commercial transactions conducted with Farmland or an entity Farmland now owns."[366] Primarily relying on *Forman* and *Howey*, the court found that the capital credits, therefore, lacked the "essential characteristics of securities."[367]

The SEC has also followed *Forman* in its "no-action letters" with respect to cooperatives generally. The no-action letter process allows counsel for a company that is contemplating taking some security-related action to request that no SEC enforcement proceeding be brought against the company if it proceeds with its contemplated action.[368] No-action letters are conditional, affirmative responses by the

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357. SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946).
358. *Farmland Indus.*, 198 F.3d at 698.
359. *Id.* at 699.
360. *Id.*
361. *Id.* at 700.
362. *Id.*
363. *Id.*
364. *See id.* at 700-01.
365. *Id.*
366. *Id.* at 700.
367. *Id.* at 699. The court declined to follow the *Reves* approach because "'capital credits' are not specifically included in the statutory definition of 'security.'" *Id.*
368. *See* Nokes, *supra* note 192, § 136.01[3][a].

SEC staff to such requests.[369] While a no-action letter does not bind the Commission with respect to future enforcement proceedings, it essentially represents the SEC staff's approval of the company's contemplated action.[370]

SEC no-action letters have indicated that a cooperative's membership stock is not a security if the stock is not freely transferable; no capital appreciation can be realized on the stock's redemption or sale; and the stock does not bear interest or dividends.[371] In addition to issuing no-action letters with respect to membership stock with these attributes, the SEC has issued no-action letters with respect to other methods of raising capital from members, including "annual dues payments, no-interest debentures, refundable and non-refundable initiation fees, reserve contributions, and various revolving" fund equities.[372]

To date, no reported court decision had addressed the issue of whether "delivery rights" stock, as such, is a "security." Membership stock in a traditional farmer cooperative and delivery rights stock in a New Generation cooperative have very different attributes. It does not necessarily follow, therefore, that because membership stock in a traditional cooperative is generally not considered to be a "security" that delivery rights stock also should not be deemed to be a "security."

Membership stock in a traditional farmer cooperative confers upon its holder the right, usually unlimited, to use the cooperative. It also confers the right to vote in the cooperative's affairs and the right to participate in patronage refund distributions based on its holder's use of the cooperative.

Most traditional farmer cooperatives limit membership stock ownership to farmers and often only to those farmers who regularly patronize the cooperative. For this reason, the transferability of the stock is usually

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369. *Id.*

370. *Id.*

371. *See* Steve F. Brault, *Equity Financing of Cooperatives: Advantageous Federal Securities Law and Tax Treatment*, 21 WILLAMETTE L. REV. 225, 243-44 (1985) (noting that the SEC may also require that only members can own shares); *see also* Kathryn J. Sedo, *The Application of Securities Laws to Cooperatives: A Call for Equal Treatment For Nonagricultural Cooperatives*, 46 DRAKE L. REV. 259, 278 (1997) (noting that the "SEC has consistently issued no-action letters when the stock of a cooperative evidences membership, is not transferable, pays no dividends, and cannot appreciate in value"); Lewis D. Solomon & Melissa B. Kirgis, *Business Cooperatives: A Primer*, 6 DEPAUL BUS. L. J. 234, 253 (1994) (noting that "[w]hen cooperatives offer their members the possibility of capital appreciation and dividends, the Commission has viewed them as securities").

372. Brault, *supra* note 371, at 244. For a discussion of the issue of whether retained equities are securities, see Terence J. Centner, *Retained Equities of Agricultural Cooperatives and the Federal Securities Acts*, 31 U. KAN. L. REV. 245 (1982); *see also* Bonnema v. Santa Anna Nat'l. Bank, 219 B.R. 951, 956 (Bankr. N.D. Tex. 1998) (holding that capital retain certificates issued to debtors by a cooperative were not "securities" under Article 8 of the Texas Uniform Commercial Code).

restricted. If any transfers are permitted, they are subject to the approval of the cooperative's board of directors.

Although they impose restrictions on eligibility and transferability on their membership stock, most traditional farmer cooperatives do not limit the number of available shares. Most traditional farmer cooperatives are "open" cooperatives whose membership never closes. Hence, since membership stock is always available from the cooperative, and the economic benefits offered by the cooperative are derived from the unlimited use of the cooperative that a single share confers, membership stock in traditional farmer cooperatives does not appreciate in value. For this reason, the only rational economic motivation for purchasing membership stock is to gain the right to use the cooperative and to therefore participate in the distribution of patronage refunds that are based on that use.

This said, the purchase of membership stock in a traditional farmer cooperative indisputably constitutes an "investment" in the cooperative—after all, "[c]ooperatives are not merely patronage creatures. They are investments too."[373] "Investment" in this context, however, means a capital contribution to the cooperative so that the cooperative will be there for the "investor" to use. Moreover, the capital a cooperative realizes from the sale of its membership stock is usually small relative to other capital contributions made by members. Traditional farmer cooperatives raise most of their member capital from retained patronage refunds and per-unit retains.

Unlike membership stock in a traditional farmer cooperative, membership stock in a New Generation cooperative does not confer the right to patronize the cooperative. It confers the right to purchase delivery rights stock. It is the delivery rights stock, not the membership stock, that confers the right to patronize the cooperative.

Delivery rights stock has some of the attributes of membership stock in traditional farmer cooperatives. It is sold only to persons who have met the cooperative's eligibility requirements and who thereby hold membership stock. Its transferability is restricted. Transfers are permitted, but only with board approval.

There are significant dissimilarities, however. First, membership stock confers voting rights, but delivery rights stock does not. Second, membership stock does not confer on its holder specific patronage rights. Delivery rights stock does. The extent to which a member can

373. H. Christopher Peterson, *The Economic Role and Limitations of Cooperatives: An Investment Cash Flow Derivation*, 7 J. AGRIC. COOPERATION 61, 75 (1992).

patronize a New Generation cooperative depends on the amount of delivery rights stock the member holds.

Third, although both types of stock constitute a contribution to the cooperative's capitalization, the outlay typically expended to acquire delivery rights stock greatly exceeds the usual nominal price of membership stock. Since each share of delivery rights stock represents the right to deliver a single standard measure or other relatively small amount of the raw product, each member usually purchases many shares. An individual member, therefore, may have a substantial amount of capital exposed to the risks inherent in the cooperative's enterprise.

Fourth, even if permitted, the right to transfer membership stock is usually of little economic value because its price is nominal and it does not confer specific patronage rights. The same is not true for delivery rights stock. Delivery rights stock confers specific and exclusive patronage rights. In addition, the distribution of the cooperative's surplus earnings is based on delivery rights stockholdings. If tradable, therefore, the per-share value of delivery rights stock will likely reflect the real or perceived value of the patronage rights that it confers.

Although board approval is a prerequisite, delivery rights stock usually can be pledged as security and transferred because New Generation cooperatives and their members benefit from both. Members often must borrow funds to purchase delivery rights stock. Since many, if not most, of their assets are already pledged as security for other loans, pledging the stock permits members to obtain the purchase price and thereby gives the cooperative greater access to member-capital than it might have had otherwise.

Later, by transferring their stock, members can receive their stock's value when they exit the cooperative or reduce their participation. From the perspective of the cooperative's board of directors, the approval of such transfers can be beneficial to the cooperative for two reasons. First, permitting a transfer of delivery rights stock to another cooperative member or persons eligible for membership allows the cooperative to "line-up" the commodity previously delivered by the transferor of the stock. Second, the cooperative is more likely to attract new members and keep current members satisfied if the members know that their capital is not "trapped" in the cooperative. By routinely approving transfers of delivery rights stock, the cooperative implicitly assures its members that they can "cash-out" if they elect to leave the cooperative or to scale-back their participation in it. Given these practical incentives,

delivery rights stock in New Generation cooperatives can be accurately described as "tradable."[374]

Finally, delivery rights stock has the potential to appreciate in value. The only way to participate in the earnings distributions of a successful New Generation cooperative is through the patronage rights conferred by delivery rights stock. Because only a limited number of shares are available, per-share values can increase with the success of the cooperative. Membership stock does not have this potential.

Delivery rights stock, therefore, has some of the characteristics of stock that is ordinarily deemed a "security"—it can be pledged, it is tradable, and it has the potential to appreciate in value. At the very least, these characteristics are likely to be material in any setting in which the issue is whether delivery rights stock is a security.[375] However, they are particularly significant factors when the cooperative membership consists of a substantial number of "just investing" farmer-members who purchase the commodity they deliver on the open market.

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374. Harris et al., *supra* note 39, at 16, 19 (noting also that delivery rights stock is sometimes leased).

375. In 1994, American Crystal Sugar registered with the SEC an offering of 1,000 shares or common stock having a par value of $10 and 18,900 shares of preferred stock having a par value of $76.77. *See* Kathy T. Wales, 1994 Report of the LTA Reporting Subcommittee on Capital Formation and Financial Structures of Cooperatives Including Use of Written Notices of Allocation, at 12-13 (Nov. 15, 1994) (unpublished manuscript on file with author). At the time, one share of preferred stock represented the right to deliver to the cooperative the sugar beets grown on one acre. *Id.* The preferred stock conferred no voting rights. *Id.* Voting rights were conferred by the one share of common stock that each member was required to purchase. *Id.* Neither the preferred stock nor the common stock paid dividends. *Id.*

Transfers of the common and preferred stock were permitted with the approval of the cooperative's board of directors. *Id.* Transfers could only be made to new or existing members, but the stock must first be offered to the cooperative for repurchase at its par value. *Id.* American Crystal Sugar, however, had never repurchased stock offered to it, and its informal policy was to not do so in the future. *Id.*

There was a limited market for preferred stock. *Id.* at 13. Under the registered offering, members as of an earlier date were given a first right of purchase. Any preferred shares remaining would be sold to eligible purchasers who had completed a "response card," and the response cards would be drawn at random. *Id.* The anticipated sale price for the preferred stock was in the range from $1,000 to $2,000 per share. *Id.*

American Crystal Sugar is not a section 521 cooperative. *Id.* at 11. Hence, its securities were not exempted from registration under the 1933 Act. *Id.* The intrastate exemption also was not available because the offering was being made to farmers in Minnesota and North Dakota. *Id.*

In light of these facts, one observer has noted that "[t]he fact that Crystal filed this registration statement suggests that Crystal concluded that there is a substantial risk that the shares of common and preferred stock are securities within the meaning of the federal securities laws and that no exemptions from the registration requirements of the 1933 Act are available for the offering." *Id.* Assuming this observation to be true, Crystal apparently concluded that the delivery rights stock of a value-added cooperative is likely to be deemed to be a "security," at least if there is a market for the stock and the attendant possibility of the stock's appreciation in value. Not only does the anticipated sale price for this particular registration indicate the potential of Crystal's preferred stock to appreciate in value, other sources reflect the same. *See* Charles V. Moore & Jay E. Noel, *Valuation of Transferable Delivery Rights for Marketing Cooperatives*, 10 J. COOPERATIVES 1 (1995).

The traditional characteristics associated with shares of "stock" are (1) their conferring on their holders the contingent right to receive dividends; (2) their transferability; (3) their ability to be pledged or hypothecated; (4) their conferring on their holder voting rights in proportion to the number of shares owned; and (5) their potential for appreciation in value.[376] Of these characteristics, only the contingent right to receive dividends has not been discussed.

Delivery rights stock does not entitle its holder to dividends. Instead, apart from receiving the price paid for the raw product at the time of its delivery, the delivery rights stockholder is only entitled to his or her proportionate share of the distribution of the cooperative's net earnings. While such a patronage refund is "contingent" upon the cooperative having net earnings, ordinarily cooperatives are required by their articles or bylaws and state law to distribute their net earnings derived from patronage business. Thus, the "contingent" right to receive dividends differs from the "contingent" right to receive patronage refunds.

Nonetheless, when delivery rights stock is held by a "just investing" farmer, the payment of patronage refunds based on the delivery of a commodity purchased on the open market could be deemed to be in the nature of a return on a capital investment rather than a return on patronage. If so, these patronage refunds would be susceptible to being characterized as an economic equivalent of a stock dividend.

When held by a "just investing" farmer, delivery rights stock is also distinguishable from the stock at issue in *Forman* with respect to the motivation for its purchase or use. The stock in *Forman* was essentially membership stock, and it was purchased by those whose exclusive motivation was to acquire housing, not to make an investment represented by the stock.[377] As the Court in *Forman* observed, "[c]ommon sense suggests that people who intend to acquire only a residential apartment in a state-subsidized cooperative, for their personal use, are not likely to believe that in reality they are purchasing investment securities simply because the transaction is evidenced by something called a share of stock."[378] This observation might be equally sound with reference to cooperative members who use the cooperative as a "home" for their production. It does not describe, however, the motivations or expectations of one who uses the stock to deliver purchased commodities. To

376. *See, e.g.*, United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851 (1975).
377. *Id.*
378. *Id.*

the contrary, such a stockholder uses the stock to receive a return on a cash investment.

Even if it is not "stock" within the meaning of the securities laws, delivery rights stock held by a member who purchases the commodity he or she delivers is likely to be an "investment contract" and therefore a "security." An investment contract requires (1) an investment of money (2) in a common enterprise (3) with the expectation of profits (4) solely from the efforts of others.[379] The first element would be satisfied since the member would have purchased both the delivery rights stock and the commodity required to fulfill his or her delivery obligation. The same can be said of the third element, the expectation of profit.

Whether the "common enterprise" and "solely from the efforts of others" requirements would be satisfied requires more scrutiny. As to the "common enterprise" requirement, if it is assumed that the cooperative is the promoter, as would certainly be the case at the time the delivery rights stock was initially offered, both "vertical commonality" and "horizontal commonality" arguably would exist. Under the "vertical commonality" test followed in the Ninth and Fifth Circuits, "[a] common enterprise is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties."[380] Here, the fortunes of a delivery rights stockholder would be interwoven with and dependent upon the efforts of the cooperative and its other members.

"Horizontal commonality," as framed by the Seventh Circuit, essentially requires the presence of "joint participants in the same investment enterprise."[381] In a cooperative with some "just investing" farmer-members, two investment enterprises arguably exist–one consisting of those who used the cooperative as a "home" for their production and another consisting of those who delivered purchased product. Those in the latter group would essentially be contributing cash to the cooperative each time they purchased raw product for delivery. Their respective returns, therefore, would be their pro rata distribution based on their cash investments. This group of members, therefore, would consist of "joint participants in the same investment enterprise."[382]

Whether the remaining element, that the expected profits are to be derived solely from the efforts of the promoter or a third party, is satisfied depends in part on whether "solely" is to be read literally. The

379. *See* SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946).

380. SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 478 (5th Cir. 1974) (quoting SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 n.7 (9th Cir. 1973)).

381. Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 277 (7th Cir. 1977).

382. *See, e.g. id.*

better view, one consistent with decisions in the Ninth and Fifth Circuits,[383] is that "solely" should not to be read literally. Instead, the inquiry is "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[384]

A delivery rights stockholder who purchases the commodity is essentially a "passive" investor, but for having the right to one vote in the affairs of the cooperative as a holder of membership stock. While this voting can be used to influence who manages the cooperative's affairs, its effect may be too diluted to ascribe to any individual stockholder anything more than a minor or inconsequential role in the "essential managerial efforts which affect the failure or success of the enterprise."[385] This is likely to be especially true if the value-added enterprise is in fact a complex and sophisticated enterprise, as is likely to be the case.

The "passivity" of the "just investing" farmer is all the more evident if the "enterprise" is viewed as encompassing both the cooperative and the farming operations that supply it with its raw product. From this perspective, the cooperative and these farming operations are essentially a single, vertically integrated "enterprise." The members, who deliver their own production to the cooperative, therefore, are contributing their labor and management to the "enterprise" and not just to their respective farming operations. The same contribution, however, is not made by members who deliver purchased raw product. Instead, they rely wholly on the labor and management of others. Thus, when compared to those who deliver their own production, the "just investing" farmer is undeniably passive.

Although a persuasive argument could be made that delivery rights stock held by cooperative members who purchased the commodity they delivered on the open market was a security, the same argument would be considerably less persuasive if the commodity was obtained from a "pool" of commingled, fungible member production. In such a case, assuming that all participants contributed to the pool the same quantity that they withdrew, the farmers who delivered commodities obtained from the pool would be using the cooperative as a "home" for member-produced production. In this respect, their motivations for acquiring the delivery rights stock, therefore, would be markedly different from the motivations of those who purchased the raw product

383. *Glenn W. Turner Enters.*, 474 F.2d at 482; *Koscot Interplanetary, Inc.*, 497 F.2d at 480.
384. *Glenn W. Turner Enters.*, 474 F.2d at 482; *Koscot Interplanetary, Inc.*, 497 F.2d at 483.
385. *Glenn W. Turner Enters.*, 474 F.2d at 482.

on the open market. To the extent that motivations matter, and *Forman* indicates that they do, this factor would favor the conclusion that delivery rights stock was not a security when held by cooperative members who accessed a "member-only pool" to obtain their raw product for delivery.

In addition, members who deliver only member-produced raw product are less susceptible to being characterized as "passive" investors. Again assuming that no member withdraws more of the commodity from the pool than he or she contributed over time, all of the members who accessed the pool will have been responsible for the raw product that was later converted into a higher-valued product by the cooperative. In other words, their management, labor, and assumption of production risks would have contributed to the cooperative enterprise.

On the other hand, even those members who purchased delivery rights stock as a "home" for their production are likely to have had mixed motives when they purchased the stock. In light of the appreciation in the value of the delivery rights stock issued by New Generation cooperatives such as the Dakota Growers Pasta Company, it is reasonable to assume that most, if not all, of the members of New Generation cooperatives were at least partially motivated to purchase their delivery rights stock for the opportunity to someday realize a gain from its appreciation. Therefore, unlike the singular motivation at issue in *Forman* to use the cooperative, the motivations underlying virtually all members' purchase of delivery rights stock include both the motivation to "use" the cooperative and the motivation to someday market the stock at a gain. While the latter motivation favors characterizing the stock as a security, the former does not.

Ultimately the question of whether delivery rights stock held by any cooperative member may turn, at least implicitly, on the question of whether the benefits associated with deeming the stock a security outweigh its costs.[386] If so, the issue would be whether the benefits of the disclosure and the protection against fraud provided by the federal securities laws outweigh the direct and indirect costs of registration, assuming no exemption from registration applies.

Many farmers understand that farming is a business and have acquired the knowledge and the skills to manage the risks associated with farming. However, the degree to which these farmers understand the risks inherent in a particular value-added enterprise without having had

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386. *See generally* Jon K. Lauck & Edward S. Adams, *Farmer Cooperatives and the Federal Securities Laws: The Case for Non-Application*, 45 S.D. L. REV. 62 (2000) (arguing with respect to membership stock in farmer cooperatives that the costs imposed by the federal securities laws outweigh the benefits).

these risks disclosed to them in the manner dictated by the registration process is less certain.

Even if it is accepted that the benefits of disclosure could be substantial, the question remains whether the cost of acquiring these benefits is commensurate with the gain. Since New Generation cooperatives obtain a large portion of their initial capital through the sale of delivery rights stock, it may be fair to assume that the direct costs of complying with the registration requirements will be borne by the cooperative's members. For a nascent cooperative struggling to find prospective members with sufficient capital to contribute the funds the cooperative needs, these costs may be enough to delay or terminate the organizational and developmental efforts. Others might find these costs burdensome, but not crippling.

Given the paucity of authority on the issue of whether delivery rights stock is a security under any circumstances, all that can be said now is that in the hands of some "just investing" farmers there is a considerable likelihood that it is. For this reason, the "just investing" farmer-member poses a potential problem for New Generation cooperatives who have such members and who have failed to consider the attendant federal securities law implications.

D. THE FEDERAL ANTITRUST LAWS

The "just investing" farmer-member can also affect a cooperative's eligibility for the limited antitrust immunity provided by the Capper-Volstead Act of 1922.[387] The Capper-Volstead Act of 1922 has been heralded as the "Magna Carta" of cooperative legislation because farmer marketing cooperatives could not exist under section 1 of the Sherman Act[388] without the limited antitrust immunity provided by it.[389]

Section 1 of the Sherman Act generally prohibits horizontal price-fixing.[390] A marketing cooperative acts on behalf of its members to fix

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387. Capper-Volstead Act of 1922, ch. 57, 42 Stat. 388 (codified as amended at 7 U.S.C. §§ 291-292 (1994 & Supp. V 1999)).

388. Sherman Act, ch. 647, 26 Stat. 209 (codified as amended at 15 U.S.C. §§ 1-7 (1994 & Supp. V 1999)).

389. *See, e.g.*, Randall E. Torgerson, *The Foundation: Capper-Volstead Remains Critical to the Future of Cooperation*, RURAL COOPERATIVES, May-June 1997, at 28.

390. *See, e.g.*, United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 223 (1940). Naked horizontal price-fixing is "per se" illegal. *See, e.g.*, Northern Pac. Ry. v. United States, 356 U.S. 1, 5 (1958). Some arrangements that involve price-fixing in the literal sense are tested under the rule of reason. *See, e.g.*, Broad. Music, Inc. v. Columbia Broad. Sys., Inc., 441 U.S. 1, 24 (1979); Nat'l Collegiate Athletic Ass'n v. Bd. of Regents of the Univ. of Okla., 468 U.S. 85, 103 (1984).

the common sale prices of the members' products marketed through the cooperative.[391]

The Capper-Volstead Act, however, offers qualified farmer cooperatives limited immunity from the antitrust laws.[392] While this immunity permits farmer marketing cooperatives to set a common price for their members' products, it is characterized as "limited" because certain activities are not protected.[393] For example, cooperatives cannot enter into combinations or conspiracies that would violate the antitrust law with entities that do not qualify for limited immunity under the Act.[394]

Only certain associations are eligible for this limited antitrust immunity.[395] First, the immunity extends only to "persons engaged in the production of agricultural products as farmers, planters, ranchmen, dairymen, nut or fruit growers" who act through an association "in collectively processing, preparing for market, handling, and marketing in interstate or foreign commerce, such products of persons so engaged."[396] This language has been construed by the Supreme Court as requiring every member of the association to be a producer of the raw agricultural products handled by the cooperative.[397] If even a single

391. *See, e.g.*, Donald B. Pedersen, *Introduction*, 23 U.C. DAVIS L. REV. 401, 408 (1990). Farmers are often characterized as "price takers" since individually they do not have the power to set or even influence prices. *Id.* at 408 n.44. The same characterization may be applied to farmer marketing cooperatives that market basic commodities such as corn or wheat. However, "[a] price fixing violation occurs upon formation of the combination or conspiracy, without regard for whether the combination has any impact on actual prices or has the capability to effectuate an agreement to fix prices." THOMAS V. VAKERICS, ANTITRUST BASICS § 4.02, at pp. 4-6 (1998).

392. This limited immunity does not extend to the Robinson-Patman Act, 15 U.S.C. §§ 13(a)-(f), 13a-13c (1994), which prohibits price discrimination in certain circumstances. *See* Harold M. Carter, *Antitrust Aspects of Agricultural Cooperatives, in* 14 NEIL E. HARL, AGRICULTURAL LAW § 137.06[5] (1996).

393. Maryland & Virginia Milk Producers Ass'n v. United States, 362 U.S. 458, 466 (1960); Treasure Valley Potato Bargaining Ass'n v. Ore-Ida Foods, Inc., 497 F.2d 203, 216 (9th Cir. 1974).

394. United States v. Borden Co., 308 U.S. 188, 197-98 (1939). However, two or more cooperatives may enter into agreements with each other if each is qualified for the limited immunity provided by the Act. Sunkist Growers, Inc. v. Winckler & Smith Citrus Products Co., 370 U.S. 19, 28 (1962). For general discussions on the limitations on Capper-Volstead immunity, see Carter, *supra* note 392, at § 137.06; 9 EARL W. KINTNER & JOSEPH P. BAUER, FEDERAL ANTITRUST LAW §§ 71.8, 71.9 (1989); 6 JULIAN O. VON KALINOWSKI, ANTITRUST LAW AND REGULATION § 51.05 (1995). For discussions more focused on the application of the prohibitions against monopolization found in section 2 of the Sherman Act, 15 U.S.C. § 2, to farmer cooperatives, see Thomas W. Paterson & Willard F. Mueller, *Sherman Section 2 Monopolization for Agricultural Marketing Cooperatives*, 60 TUL. L. REV. 955 (1986); David L. Baumer et al., *Curdling the Competition: An Economic and Legal Analysis of the Antitrust Exemption for Agriculture*, 31 VILL. L. REV. 183 (1986); Stephen D. Hawke, Note, *Antitrust Implications of Agricultural Cooperatives*, 73 KY. L. J. 1033 (1984); Michael D. Love, Recent Development, *Antitrust Law*–Fairdale Farms, Inc. v. Yankee Milk, Inc.–*The Right of Agricultural Cooperatives to Possess Monopoly Power*, 9 J. CORP. L. 339 (1982).

395. "The word 'cooperative' never appears in Capper-Volstead." Donald A. Frederick, *The Impact of LLCs on Cooperatives: Bane, Boon, or Non-Event?*, 13 J. COOPERATIVES 44, 47 (1998).

396. 7 U.S.C. § 291 (1994).

397. *See* Nat'l Broiler Mktg. Ass'n v. United States, 436 U.S. 816, 822-23, 827-29 (1978) (holding that a broiler marketing cooperative whose membership included members who owned or maintained neither a breeder flock, hatchery, nor "grow-out" facility was not entitled to the limited

member of the association is not a producer, the Act's protection is lost.[398]

In addition, the activities of the association must be done for the mutual benefit of the members as agricultural producers.[399] The association also must operate on a one member, one vote basis or limit any dividends on stock or membership capital to no more than eight percent per year.[400] And finally, the association must do more business, measured by value, with members than with nonmembers.[401] This final requirement, when coupled with the requirement that the association must operate for the mutual benefit of its members, "means that all commodities handled which are not produced by the members must be regarded as nonmember business. Therefore, commodities purchased by members and delivered to an association constitute nonmember business."[402]

New Generation cooperatives typically operate on a one member, one vote basis. The limit on dividends found in the Capper-Volstead Act therefore is unlikely to determine the cooperative's eligibility for the Act's limited immunity. A cooperative that did not operate on a one member, one vote basis could run afoul of this requirement if its returns to members who purchased a commodity handled by the cooperative were deemed to be dividends on the members' delivery rights stock and the return exceeded eight percent per annum.

For the cooperative that operates on a one member, one vote basis and receives deliveries from members who had purchased the commodity they delivered, eligibility for the Act's limited immunity could turn on two issues: whether these deliveries constituted nonmember business and whether the value of this business exceeded the value of member business. The only extant authority holds that "all commodities

protection of the Capper-Volstead Act); Case-Swayne Co. v. Sunkist Growers, Inc., 389 U.S. 384, 392 (1967) (holding that a cooperative whose membership included nonproducers, specifically, handlers of agricultural products, was not eligible for Capper-Volstead Act protection). For discussions of the *Nat'l Broiler Mktg. Ass'n* litigation, see Worth Rowley & Marvin Beshore, *Chicken Integrators' Price-Fixing: A Fox in the Capper-Volstead Coop*, 24 S.D. L. REV. 564 (1979); Charles Gordon Brown, United States v. National Broiler Marketing Association: *Will the Chicken Lickin' Stand?*, 56 N.C. L. REV. 29 (1978).

398. *Nat'l Broiler Mktg. Ass'n*, 436 U.S. at 828-29. However, in *Alexander v. Nat'l Farmers Org.*, 687 F.2d 1173, 1185-87 (8th Cir. 1982), the court held that a cooperative whose bylaws prohibited non-farmers from voting was entitled to Capper-Volstead Act protection even though it had received membership dues from a small number of non-farmers as the result of careless record keeping. A "member," in this context, has been held to be a person with voting rights in the association. *See* Agritronics Corp. v. Nat'l Dairy Herd Ass'n, 1994-2 Trade Cas. (CCH) ¶ 70,758 (N.D.N.Y. 1994) (ruling that a "member," for purposes of the Capper-Volstead Act, is someone with the power to participate in the control and policy making of the association through voting or some equivalent form of power).

399. *Legal Phases of Farmer Cooperatives*, *in* USDA FCS INFORMATION 100, at 300 (May 1976).

400. *Id.*

401. *Id.*

402. *Id.* at 301.

handled [by the association] which are not produced by the members must be regarded as nonmember business."[403] This proposition is based on the Act's requirement that eligible associations must be "operated for the mutual benefit of the members thereof as such producers."[404] It is also supported by the legislative history of the Act.

In explaining why a level of nonmember business was permitted, the report of the Senate Committee on the Judiciary stated as follows:

> The bill before us during the last session authorized the organization of associations dealing in "products of their members." The bill now under consideration authorizes them to deal in the "products of persons so engaged." Obviously, under the former the associations would be restricted in their dealings to members; in the latter, though they are restricted as to the character of the products in which they may deal, it is clear that they may deal with any person in such products, whether he be a member or not.
>
> The bill has for its purposes the removal of obstacles, if such there be in the Federal statutes, in the way of the organization of cooperative farm marketing associations, a purpose with which the majority, at least, of your committee is in full sympathy. It maybe [sic], and probably is, true that such associations cannot operate with the highest degree of success, or with that degree of success which your committee would be glad to see attend their efforts, unless they are permitted to deal to some extent in the products of nonmembers similar in character to those handled for the members. But the protection of the statute ought not to be given to a small number of persons of the classes named in the bill who contribute from their own farms an inconsiderable quantity of the product handled by the association.[405]

Under this authority, commodities purchased on the open market for delivery to the cooperative would be nonmember products. However, if the purchased commodities were produced by members, they should constitute member products, even if the member delivering them did not actually produce them. In other words, commodities

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403. *Id.*
404. 7 U.S.C. § 291 (1994).
405. USDA FCS INFORMATION 100, *supra* note 399, at 301 (quoting 62 Cong. Rec. 2121 (1922)).

delivered from a "pool" of member-produced commodities should constitute member products.

A cooperative that handles more nonmember products than member products, measured by the products' value, could face antitrust liability. For example, assume that an ethanol cooperative has more corn than it needs to produce ethanol. It therefore decides to sell this corn on the open market and to return its net earnings from the sale to its members as a part of its patronage refunds. Such a sale would constitute the marketing of the members' corn at a price fixed by the cooperative acting on behalf of each of its members. Only a cooperative qualifying for the Capper-Volstead Act would enjoy immunity from liability for such a sale.[406]

On the other hand, if this ethanol cooperative never sold excess corn on the open market, its potential exposure to antitrust liability would likely be the same as it would be for any other business that did not have the limited immunity provided by the Capper-Volstead Act. While it could unilaterally set the price for its ethanol, it could not act in combination with any other ethanol producer that did not qualify for the Act's limited immunity in setting ethanol prices or engage in any other conduct prohibited by the antitrust laws.

Whether qualifying for the protection of the Capper-Volstead Act matters to a New Generation cooperative therefore turns largely on the activities of the cooperative. If qualifying for the protection matters, the "just investing" farmer presents a risk to eligibility for that protection.

E. THE FARM CREDIT ACT

The Farm Credit Act of 1971[407] authorizes certain federally chartered institutions within the Farm Credit System (System) to lend funds to farmer cooperatives that meet its eligibility criteria.[408] The Act authorizes lending to farmer cooperatives that meet four basic requirements.[409] These requirements, however, apply only to the initial loan.[410] A cooperative that has received a loan continues to be eligible without

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406. 7 U.S.C. §§ 291-292.

407. Farm Credit Act of 1971, P.L. 92-181, 85 Stat. 583 (codified as amended at 12 U.S.C. §§ 2001-2279cc (1994 & Supp. V 1999)).

408. Historically, lending to farmer cooperatives has been the mission of twelve regional Banks for Cooperatives within the Farm Credit System. *See, e.g.*, Daniel L. Monson, *Farm Credit Act of 1971 and Its Relationship to Cooperatives*, *in* PROCEEDINGS OF THE NATIONAL SYMPOSIUM ON COOPERATIVES AND THE LAW 158 (1974). More recently, as a result of consolidations within the System, two Farm Credit System institutions, the St. Paul Bank for Cooperatives and CoBank, ACB, have carried that responsibility. These two institutions have now merged into CoBank, ACB.

409. *Id.*

410. *Id.*

regard to these requirements "for so long as more than 50 percent (or such higher percentage as is established by the bank board) of the voting control of the association is held by farmers, producers or harvesters of aquatic products, or eligible cooperative associations."[411]

First, the association must operate on a "cooperative basis."[412] The implementing regulations do not define this term, but they define a "cooperative" as

> any association of farmers, ranchers, producers or harvesters of aquatic products or any federation of such associations, or a combination of such associations and farmers, ranchers, or producers or harvesters of aquatic products that conducts business for the mutual benefit of its members and has the power to:
>
> (I) Process, prepare for market, handle, or market farm or aquatic products;
>
> (ii) Purchase, test, grade, process, distribute, or furnish farm or aquatic supplies; or
>
> (iii) Furnish business and financially related services to its members.[413]

Second, no member of the association can have more than one vote, irrespective of the amount of stock or membership capital held by the member.[414] Alternatively, the association cannot pay dividends in excess of an annual percentage specified in regulations issued by the Farm Credit Administration.[415]

Third, the association must not deal in farm products or products processed from farm products, farm supplies, or farm services, "with or for nonmembers in an amount greater in value than the total amount of such business transacted by it with or for members, excluding from the total of member and nonmember business transactions with the United States or any agency or instrumentality thereof."[416]

Fourth, for most associations, not less than eighty percent of the voting control of the association must be held by "farmers, producers or

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411. 12 U.S.C. § 2129(a).

412. *Id.*

413. 12 C.F.R. § 613.3100(a)(1) (2000). The regulations also provide that "[a]ny creditworthy private entity operated on a nonprofit basis" and that meets the other requirements of eligibility shall be eligible if it is "organized to benefit agriculture in furtherance of the welfare of the farmers, ranchers, and aquatic producers or harvesters who are its members." *Id.* § 613.3100(b)(2)(iii).

414. 12 U.S.C. § 2129(a)(1).

415. *Id.* § 2129(a)(2). The current regulations restrict dividends "to 10 percent per year or the maximum percentage per year permitted by applicable State law, whichever is less." 12 C.F.R. § 613.3100(b)(1)(iii)(B).

416. 12 U.S.C. § 2129(a)(3).

harvesters of aquatic products, or eligible cooperative associations."[417] The minimum percentage is sixty percent for local farm supply associations and their competitors that have historically served a community "that would not adequately be served by other suppliers and have experienced a reduction in the percentage of farmer membership due to changed circumstances beyond their control such as, but not limited to, urbanization of the community."[418] The Act's implementing regulations permit bank boards to set a higher percentage.[419]

"Just investing" farmer-members could disqualify their cooperative from obtaining System institution loans. As noted above, a cooperative is not eligible to borrow from a System institution if (1) it pays dividends on its stock in excess of the annual percentage specified in the regulations of the Farm Credit Administration[420] or (2) deals in a greater value of nonmember products than member products, excluding business transactions with the federal government.[421] Thus, if the patronage refunds derived from the delivery of a commodity purchased on the open market were deemed to be dividends on the delivery rights stock and the dividends exceeded the maximum level permitted, the cooperative would be ineligible. Likewise, if these same deliveries were deemed to be nonmember products and their value exceeded the value of member products, ineligibility would also result.

"Just investing" farmer-members, however, are not likely to have an effect on a cooperative's ability to borrow from a Farm Credit System institution if the cooperative has already qualified for a loan. This result appears to be dictated by the Farm Credit Act's provision permitting a cooperative that has received a loan to continue to be eligible without regard to the initial eligibility requirements "for so long as more than 50 percent (or such higher percentage as is established by the bank board) of the voting control of the association is held by farmers, producers or harvesters of aquatic products, or eligible cooperative associations."[422] Since the manner in which the obligations represented by delivery rights stock are fulfilled does not effect the voting control of a cooperative, it would not have an impact on how control was allocated in the cooperative.

417. *Id.* § 2129(a)(4).
418. *Id.* § 2129(a)(4)(B).
419. 12 C.F.R. § 613.3100(b)(1)(I)(B).
420. The current limit is ten percent per year or the maximum rate permitted under state law, whichever is less. 12 C.F.R. § 613.3100(b)(1)(iii)(B).
421. 12 U.S.C. § 2129(a)(3).
422. 12 U.S.C. § 2129(a).

VI. CONCLUSION

The possibility of having "just investing" farmer-members exists for many New Generation cooperatives, particularly those that annually process a relatively large quantity of raw agricultural product delivered by many members. Though a possibility, it is not necessarily inevitable. Avoiding it, however, may require more vigilance than a large cooperative can effectively maintain. Some actions may help, particularly if the cooperative's "just investing" farmers are purchasing the raw product to avoid the costs and inconveniences of delivery schedules. As this article suggests, the possibility of having a "just investing" farmer membership may be reduced by mitigating the inconveniences and costs of delivery schedules through the use of a "pool" of segregated member-produced product from which individual members can withdraw for delivery to the cooperative quantities equal to those they deposited in the pool.

The potential consequences of not addressing the "just investing" farmer problem can be serious. For example, the loss of the benefit of single-taxation under Subchapter T for failing to operate on a cooperative basis could require the cooperative to reorganize as a limited liability company if it desires to remain eligible for single-taxation. While other potential consequences, such as those flowing from the offer or sale of unregistered securities, might not result in the cooperative's cessation of business as a cooperative, they nonetheless would pose obstacles to the cooperative's success. The challenge for New Generation cooperatives, therefore, is to recognize the possibility of encountering the "just investing" farmer problem and to find an effective and workable way to address it.